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# EXECUTIVE SUMMARY

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A lot has changed in the year since the Fundación de Estudios Financieros published its first report on the euro, *La Crisis en Europa, un problema de Crisis Soberana o del Euro*[1]. And it is fair to say that nearly all of this has been positive. Greece is no longer the insoluble basket case threatening to take monetary union down with it; the European Central Bank, the ECB, is acting ever more like a normal central bank and no longer seems so constrained by anachronistic inflexibility; the Eurozone has built up its institutional capacity and made progress towards economic integration that, whilst desperately slow and excessively erratic, has been in the right direction; and the foundation have been put in place for banking union, moving beyond what was essentially a system of multiple fixed exchange rates. As a result, the euro seems no longer in danger and its disappearance no longer inevitable, although a lengthy period of institutional instability awaits.

Greece is no longer a catastrophe, because: (i) there is a serious government in office that seems committed to the current adjustment programme; (ii) European governments have finally accepted that resolving the sovereign debt problem requires debt-relief, first on debt in private hands and ultimately that held by public bodies; orderly debt relief, the first instalment of which occurred through the successful *buyback* in December; and (iii) the possibility of a planned Greek exit from Monetary Union is no longer seen as a clean surgical operation that might be possible without serious collateral damage -systemic contagion- that might undermine the whole institutional structure of the single currency. Greece has also spurred on other bailout countries, such as Portugal and Ireland, inoculating them politically against the lure of miraculous populist solutions. It has also obliged European authorities to honestly face up to the technical difficulties of a structural adjustment process requiring rather more *fine tuning* than voluntaristic fiscal consolidation.

The ECB has started acting as lender of last resort for the European financial system. Following the ECB President's 26 July declaration that he would do "whatever it takes to save the euro", on 2 August the ECB approved *Outright Monetary Transactions* (OMTs), unlimited purchases of short-term (shorter than three years) debt in secondary markets, providing the instruments needed to head off any future exchange rate crisis. Following serious internal debate, and a painful rupture with the Bundesbank, the ECB has had to recognise that its main functions is not just to maintain the value of the single currency, but also to ensure its survival. This has obliged it to resort to unorthodox and unconventional instruments -such as bond purchases and providing unlimited liquidity- to ensure that European financial markets, threatened with fragmentation and renationalisation, function effectively.

[1] Fundación de Estudios Financieros, Madrid, November 2011, edited by Fernando Fernández.

The almost total disappearance of transnational monetary flows in the Eurozone in 2012: (i) led to failure of the ECB's strategy of injecting liquidity, as the monetary multiplier did not respond, almost causing the euro to implode through a massive contraction in the liquidity available to problem countries; and (ii) plunged the Eurozone back into recession in the second half of the year. However, as we will see, OMTs are also controversial. There are two main criticisms, although these are somewhat contradictory. OMTs are criticised because government debt purchases are subject to political decisions -the adjustment programme for the country approved by the Eurogroup- putting the ECB at the mercy of the government of the day. However, the ECB is also being criticised for its absolute discretion over OMTs, giving itself wide scope for action and refusing to commit to setting a certain spread, or to even publish the level it considers reasonable and compatible with monetary union working effectively[2].

There are many complex dimensions to the economic integration of the Eurozone, and many problems remain. We shall address many of these in this second Report. Bringing the workings of the Eurozone closer to the ideal of an optimal currency area will be neither easy nor quick. But it cannot be denied that significant progress has been made. Agreements were reached in 2012 on: (i) reinforcing European fiscal stability mechanisms, modifying the Stability and Growth Pact to make it more functional, preventive and effective:[3] (ii) changing national constitutions and laws of similar stature to establish budget balance as a key part of the European architecture; (iii) launching a procedure to correct macroeconomic imbalances, for the first time recognising that balance of payments imbalances are unsustainable, focusing specifically on adjustments in the private sector and the real economy[4] ; and (iv) creating a Permanent Stabilisation Fund for the Eurozone, the recently launched European Stability Mechanism (ESM), replacing the temporary and extraordinary European Financial Stability Facility.

Banking Union, widely regarded by the academic community as an essential prerequisite for the sustainability of a single currency, was formally raised for the first time in an official European debate in a speech by President Van Rompuy in April, being set out legally at the European Summit in June. In the six months since, all European governments, including Germany, have accepted that this means three things: a single regulator and supervisor for the Eurozone financial system; a European Banking Resolution Authority capable of intervening, restructuring and liquidating banks, in cooperation with -but totally independent from- national authorities, as we saw with the recapitalisation of the Spanish banking system; and, a European Deposit Guarantee Scheme to stem capital flight and encourage banking competition in the Eurozone without the stacked deck of the relative strength of financial institutions in their domestic markets.

The path to Banking Union is probably one of the best examples of the unbearably ponderous grind of the European machine, but also of its determination and unstoppability once it gathers momentum.

[2] Unlike the IMF, which in its September 2012 *World Economic Outlook* estimated the reasonable risk premium for fiscal stress with no perspective of devaluation to be 200 basis points.

[3] On 2 March all European Governments, with the exceptions of the United Kingdom and the Czech Republic, signed the new Treaty on Stability, Coordination and Governance (TSCG), more commonly referred to as the *Fiscal Compact*, which assigns a great deal of fiscal sovereignty to supranational authorities.

[4] This mechanism set up a Macroeconomic Imbalances Procedure similar to that for the public sector deficit and also provides, more importantly, for publication of a six-monthly Report on Macroeconomic Imbalances and a Monitoring Indicators Scorecard for progress on integrating the real economy.

The European Commission approved the notion of banking union on 30 May 2012. On 19 June at the Los Cabos G-20 summit in Mexico, the Europeans undertook to make decisive progress towards closer financial integration, including "banking supervision, resolution and recapitalisation and a deposit guarantee fund". The European Council approved the launch of banking union on 28-29 June, instructing the Commission to present a specific proposal for this, which it did in September. This proposal was discussed by the Council in November and finally approved in December. During this process, the launch timetable was put back a year: to March 2014 for the adoption of a Single Supervisory Mechanism into the ECB, and to June 2014 for the Resolution Authority. Small banks were temporarily excluded to accommodate German savings banks, which did not wish to be supervised internationally; all specific references to a date for deposit guarantees to come into effect were lost; and the problem of *legacy assets*, Bank debt at the start of the union, was left for another date. But the EU machine is now in gear and the process is unstoppable. The length and complexity of the process is no doubt exasperating for the financial markets and explains many of the difficulties that have arisen, particularly how a manageable local debt crisis spiralled into an exchange crisis of -it is no exaggeration to say- systemic and global proportions. But this is Europe, and it isn't going to change any time soon. But I would also like to think that the markets have now finally realised that this slowness also guarantees the irreversibility of the integration process.

In 2012, Europe peered over the edge of the abyss of the collapse of Monetary Union. Europeans saw the size of the drop and estimated the costs. And concluded that the price would be intolerably high.

Markets have also noted this resolve to sustain the Monetary Union. The markets might be abstract entities, but they can be lethal: Europeans all too frequently slag them off during public debates, whilst courting them in private. But they have finally accepted the obvious: the euro is a political project on which the European Union has staked its future. It is a political project that even European governments have struggled to fully understand, and which their people are only part way to understanding. This political project is only sketched out in the Maastricht Treaty, which was really only a draft hazily outlining what might follow, but this was essential at the time. These current crises are an opportunity to rebuild the route. It is a painful opportunity, but unfortunately necessary as we -and by "we", I mean not just politicians, but also the public, consumers, producers and the electorate- were overwhelmed by complacency and indolence in the good times.

The political project for refounding the euro has now been defined. It can be found in what is sometimes referred to as the Four Presidents document[5]. This is not the finished article. It is a work in progress, but one which has been approved technically by all the relevant bodies and supranational authorities. It is bound to undergo changes during public discussion with stakeholders, but the decision to re-establish the foundations of the euro has been taken, and it is irreversible. International investors now understand this, and are no longer willing to bet on Monetary Union falling apart. Risk premiums have come down substantially throughout the Eurozone. They will not fall much further as, although the route is well defined, investors are discounting the inevitable obstacles and the ever-present risk of bumps en route, both nationally and at the European level. But neither will they rise significantly, if what has been agreed is respected and implemented in a timely fashion.

[5] See *Towards a Genuine Economic and Monetary Union* submitted on 5 December 2012 by Herman van Rompuy, President of the European Council, in close collaboration with José Manuel Barroso, President of the European Commission, Jean Claude Juncker, then President of the Eurogroup and Mario Draghi, President of the European Central Bank.

This is a new scenario for Spain and for the European Union, including the UK and other *out* countries, and for the world as a whole. It is worth understanding this scenario in some detail, because this is crucial not only for recovery in Spain, but also for the role of Europe in the 21st century, when we will no doubt see the burgeoning economic might of Asia consolidated. This scenario raises many questions, because the devil is always in the details, but so are the opportunities. This book aims to explain this new scenario, to analyse its fundamentals and underline the decisions that are still pending. But we will not just analyse the measures announced or critically assess the alternatives: we will go a step further and make specific proposals for defining our common future. The Fundación de Estudios Financieros is convinced that Spain must be more than just a passive observer or a loyal partner that does what it is asked. Spain has a moral obligation, and the effective capacity, to be one of the architects of reform.

To meet this objective, this report consists of seven chapters that review various institutional aspects of the design of the new foundations of Monetary Union. All of the authors have asked themselves the same question: what needs to change for Monetary Union to work and to become functional? This means not just guaranteeing its survival -an ambitious objective in itself in today's world- but achieving the founding objective of making the Eurozone the most dynamic and fairest economic area in the world.

As I have written elsewhere[6], "Monetary Union came into being in the midst of scepticism, if not outright hostility from the academic profession".

There were many amongst us who, always prone to fanciful conspiracy theories to conceal their own ignorance, invoked American apprehension at the birth of a new currency and a new empire that aspired to rival the dollar and deprive it of its leading role worldwide. But paranoia is a poor economic advisor.

The most enlightened among Europeans themselves knew that we were setting in motion a process that would lead ineluctably to a strengthening of the European Political Union. Romano Prodi, then president of the European Commission, could not have said it more clearly at the time, although nobody chose to heed him "I am sure the Euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created."[7].

This idea that the European crisis is not imported, that it is not a consequence of the international financial crisis, and that rather it is a fundamental product of failures in the design of Monetary Union itself, and the limitations that political reality in the 1990s imposed on its birth, has been gaining ground and has now become the official doctrine. As the Commission finally recognised, "in good part these vulnerabilities stemmed from features of the original institutional setup of EMU"[8].

The Commission goes on to list the fundamental failures in this mistaken and insufficient design: (i) Unlike other monetary unions, there is no centralised fiscal policy function and no centralised fiscal capacity; (ii) the coordination of national economic policies beyond the budgetary area relied on *soft* instruments –peer pressure and recommendations– and had a limited impact on the actions of individual Euro Area Member States; (iii) the European Central Bank (ECB) relied on national bonds for its open market operations, thereby conferring upon them the top-quality status required for central bank collateral... considerably limiting market discipline, despite differences in national budgetary performances; (iv) despite increased market integration, the responsibility for prudential supervision and crisis management remained predominantly at the national level; and (v) the lack of an effective mechanism to mutualise the response to risks from the banking sector.

[6] Fernando Fernández, "Al rescate del euro", *Papel Especial de la Fundación Faes*, N° 163, Madrid, November 2012.

[7] Romano Prodi, address to the European Parliament, December 2001.

[8] "A blueprint for a deep and genuine economic and monetary union. Launching a European Debate", European Commission Communication, Brussels, 11 November 2012.

The similarity between this accurate but somewhat tardy official diagnosis and that published by the Fundación in its first report on the Euro is striking. Our Report concluded with ten lessons from the crisis that I cannot resist repeating here,[9] because they remain as current as ever, and they have served as a guide for writing this second Report: (i) this is a crisis in EMU itself; (ii) overcoming the crisis requires political and institutional development in the direction of European federalisation; (iii) one of the priorities is greater fiscal coordination and integration; (iv) in exchange for which, progress is needed towards mutualisation of Member State government debt; (v) special enduring intervention mechanisms will be required in countries in particular difficulties; (vi) fiscal integration must respect the principle of subsidiarity; (vii) Europe must reduce its public debt levels, meaning that fiscal consolidation is inevitable, although we can discuss the pace of consolidation; (viii) the EMU was, and is, not an integrated financial area, and this must be built by centralising regulation, supervision, resolution and bank deposit guarantees at the European level; (ix) the ECB has a fundamental role in funding the transition to this new system, but it cannot become the lender of last resort for governments; and (x) finally, we must return to economic growth, but through competitiveness, not more public spending.

The fact is that the process of refounding the euro is finally underway, and it has reached cruising speed. However, the technical details are very important for both Europe and Spain: in the ultimate analysis, this is a dual process of ceding sovereignty and distributing costs.

The process is similar to the Maastricht Treaty negotiations in the 1990s. The difference is that Spain was then an emerging country that could overplay its hand by being one of the founder members of the euro, but now it is a struggling economy forced to resort to European funding due to errors in the way that it has managed itself: these errors are summarised in the inability of the previous government to understand what Monetary Union really meant, and its ingenuous and culpable ignorance of the economic orthodoxy. But the weakness of Spain's position should not be used as an excuse for not contributing ideas for refounding the monetary union. And this is the purpose of this report, which seeks to define and set out solutions to some of the now widely recognised institutional failures in the design of the euro.

We will start by analysing the changes that have taken place in the European Central Bank, and those still needed today. In this, we will focus in particular on whether the ECB's current statute is sufficient for the role it will have to play in the banking union. We will then address Target, the real-time gross settlement system that forms a central pillar of the euro-area payment system. Target has been deeply criticised in some political circles, particularly in Germany, as a result of misinterpretation of national imbalances resulting precisely from the breakdown in the European inter-bank market.

We will then deal with the Treaty changes needed for progress towards the genuine economic union that currently seems to dominate the official agenda, addressing the creation of a European Treasury and fiscal rule reform in the Eurozone.

[9] See op. cit. particularly the final section of the executive summary "Ten conclusions".

These are central aspects of the debate, and the focus of all the aspirations and contradictions that are the inevitable result of a new Economic and Monetary Union. Such a union will involve an increase in permanent transfers of tax revenues between member states as a stabilisation mechanism, rather than just as extraordinary flows to offset the costs of externally-funded structural adjustment processes. The final two chapters will deal with banking union. The first of these will set out the steps taken and those which are as yet only hazily sketched out, but nonetheless inevitable, in the integration of banking supervision and the banking resolution model. The second will critically examine the radical changes that have occurred to the rights and duties of individuals, shareholders and bank creditors as a result of this new financial system, where concepts such as *burden-sharing* and *bailing-in* have become familiar as part of the objective of minimising the cost of financial crises to the taxpayer.

Before going any further, I would first like to summarise the articles in this report. This will not be a thorough summary; rather I will simply highlight some of the main conclusions, presenting these through the prism of what I personally understand to be the steps required to guarantee the viability and sustainability of European Monetary Union. This summary is therefore deliberately biased by my own opinions, based on the issues covered and the contributions of the individual authors. Of course, I bear full responsibility for what is presented here: the contributors are only responsible for their own articles, and I am aware that some of the authors do not necessarily agree with all of my suggestions and interpretations. In fact, on occasions I expressly differentiate their points of view from my own: this benefits the reader, who can weigh the arguments for and against before making up their own minds on the issue.

I am sure that the authors will forgive me for taking this liberty. And I must of course recognise that their contributions were essential in forming my own opinions. I have learnt a great deal from them, and without their contributions, many of the ideas presented here would never have arisen or would not have been worth particular attention.

I believe I would be correct to say that all of the authors agree with the core argument of this work: the Monetary Union will not survive without decisive progress towards real banking, fiscal and economic union, without progress towards European federal integration: there cannot be much more delay in this, but it also requires a great deal of political vision. We can discuss and disagree about the details, including the pace and intensity of the integration needed; but we cannot disagree about the ultimate objective and the urgent need for a roadmap to settle the expectations of international investors, gaining their confidence and redirecting speculative flows by ending "redenomination risk", which is really just a new euphemism for what we traditionally called devaluation or exchange rate risk. If we are not able to firmly entrench the opinion that monetary union is -as stated in the Maastricht Treaty- permanent and irreversible, the euro will not survive, and Europe will, as a result, be less prosperous and less safe, and a much worse place to live.

We will start by analysing the European Central Bank and the need for changes to its activities and procedures. Antonio Sáinz de Vicuña y Barroso[10] is in a strong position to comment on the Bank. He is unequivocal and gets straight to the point, even if his opinion, which we could regard as pragmatic, goes somewhat counter to the prevailing tide. Although Treaty reform may be desirable and relevant, it is neither necessary nor appropriate. Europe has made considerable progress by intelligently developing and applying existing Treaties through secondary legislation; and Treaty reform is a lengthy and complex legal process, with uncertain results.

[10] General Counsel of the European Central Bank and Chairman of its Legal Committee.

The author argues that the current legal framework, with the two minor reforms affecting monetary union under the Nice (2001) and Lisbon (2007) Treaties, has enabled wide-ranging reforms that were crucial in the European response to the crisis. This has included the creation of European regulatory and supervisory bodies for financial markets; strengthening the budget discipline regime; creating the European Systemic Risks Board; and finally, resulting from the June 2012 decision, the assignment of specific micro-prudential supervision functions over credit institutions in the Euro Area to the ECB, the creation of a European Deposit Guarantee Scheme and a Credit Institution Resolution Authority.

As is to be expected, the author makes a passionate and well argued defence of the ECB's actions in the secondary debt market. Article 18.1 of the ECB Statute clearly authorises the Bank to intervene in the markets, buying and selling assets in pursuit of its monetary policy. However, Article 123 of the Treaty prohibits it from funding Member States. But, by operating autonomously and on its own account in secondary markets, "the Eurosystem only operates with banks, not with Member States". The Council decision of September 2012 creating a new intervention programme (OMTs) reinforced this by making these instruments conditional on a commitment to the Eurogroup by the State issuing the debt to adopt the adjustment measures needed to re-establish a budget consistent with the Treaty on the Functioning of the European Union (TFEU)". This is an interesting argument that seeks to deal with the criticism that, through OMTs, the ECB has taken a dangerous step by subordinating its monetary policy actions to the existence of a fiscal agreement between a member state and a European authority.

This point remains controversial. Leaving aside legal logic, it is difficult to comprehend how the ECB might remain passive and allow uncontrolled implosion in the absence of a fiscal agreement, if it considered survival of monetary union to be in peril; we can clearly deduce this from President Draghi's own words this summer when announcing this new intervention facility.

If this were the case, it would be failing the mandate set out in its Statute, not to mention the spirit of its President's words, as its actions would be conditional on those of governments, if only by omission. In essence, this is the position of many Spanish and Italian economists, who consider that current spreads of around 400 basis points are unsustainable because they would result in a gradual death through financial asphyxia of the industrial and productive capacity of the economies facing such funding costs. These are the same economists who are urging the ECB to act now, and to use what are effectively *weapons of mass destruction* -OMTs- to reduce *spreads* to target levels considered to be around 200 bp. They are also the economists urging the Spanish and Italian governments to immediately request a bailout by activating a financial assistance programme under the European Stability Mechanism. And these economists are also blaming Merkel's government, as personified by the Chancellor, for lacking solidarity and being tight-fisted and short-sighted by putting their electoral interests above the collective welfare of the Eurozone.

It is a pity, but things are not quite so simple. If, faced with implosion of the Euro Area, the ECB were to embark on a programme of discretionary debt purchases to bring spreads to such sustainable and reasonable levels, it would also be at risk of failing to comply with the mandate in its statute of ensuring the stability of the single currency, whilst also generating serious moral hazard: what incentive would there be for governments to persevere with unpopular and painful adjustments if in the end the ECB would blink first and come to their aid? This would particularly be true if such debt purchases were not accompanied by a fiscal programme to get the public finances of the affected countries back on a sustainable path.

This solvency condition obliges the ECB to consider fiscal questions, just like any other central bank in the world.

This discussion serves to dispel a fallacy that is all too widespread: that the European Central Bank is in some way exceptional. There is nothing in the ECB statute, its monetary policy decisions prior to the crisis, its recourse to unconventional policies in response to a crisis in which no central bank was happy just to reduce interest rates to practically zero, or in its search for ad-hoc mechanisms to get the monetary multiplier working again that marks it out as exceptional. What is different, very different, if not to say unsustainable, is the environment in which it operates: absence of a fiscal authority it can engage in a critical and constructive dialogue on the fiscal and monetary policy mix required as the cycle evolves; and the absence of a banking regulator and supervisor to ensure the stability of credit institutions and the financial system as a whole.

In summary, the most urgent reform for the ECB involves not itself, but the creation of European fiscal and supervisory bodies with the same federal European nature as the central bank itself. Progress has been made in this direction through the increase institutional development of the Eurogroup with the ESM coming into operation and the recent decision to include a single supervisor within the ECB. But there is a long way to go, both legally and politically, before we achieve a reasonable degree of maturity in cooperation and dialogue between European institutions of different legal and political stature.

Despite his sceptical position, in his article Sáinz de Vicuña argues precisely for some of the reforms to the ECB Statute that would be desirable in a hypothetical scenario of political agreement on its reform.

Such reforms would be of very varied importance and urgency, covering: (i) the complex new supervisory governance system; (ii) an increase in the number of executive board members to re-establish the balance between the federal centre and the national periphery; (iii) improvements to the procedure for appointing executive board members; (iv) involvement of the president of the Eurogroup rather than Ecofin on the ECB Governing Council; (v) the capacity of the ECB to create specialist agencies, for example a European bond registry or a Eurosystem mint; and (vi) the capacity to organise fiduciary currency production, transport and logistics, and not just to authorise issuance.

The integration of banking supervision in the ECB is obviously the most complicated and important of these, although it is not necessarily the most difficult as some others involve significant power sharing. Three major decisions were taken at the last summit: (1) the supervision authority was established as part of the European Central Bank, as in most euro countries -with the notable exception of Germany- but not worldwide; (2) price stability cannot be subordinated to financial stability and the latent conflict of interest between these two objectives will be resolved under normal circumstances by creating a governance body independent of the current Council for supervisory decisions. However, in the event of conflict, the Council will have the final word as it has a veto right over the decisions of the supervisory council; and (3) non-euro countries will not be subject to this single supervisor, unless they explicitly request this through a special procedure, and they have received official guarantees that the London-based European Banking Authority, which all European Union countries belong to, will continue to be the basic regulator for European banking. However, it will not automatically be controlled by the weight of votes of the ECB supervisor, as decisions require a double majority. This may seem less relevant for Spain, but it is crucial for the UK, and given the importance of London's financial industry, for all European banks that would run the risk of being subject to two differing legal systems.

This is a good example of a point we frequently overlook in the Spanish debate: Monetary Union is a unique and particularly complex exercise in economic integration that must be compatible with the legality and efficiency of the single market throughout the European Union. And this compatibility cannot only be temporary, as the founding aim that all European Union countries would inevitably adopt the single currency is clearly an unrealistic pipedream.

The costs of the required increase in Eurozone integration cannot -and must not- hasten the exit of those countries that have not adopted, and are not likely to want to adopt, the euro.

It is perhaps surprising that the reforms considered have not included supplementing the inflation objective with an employment objective, as the US Federal Reserve has recently done. This is a development of the US central bank's traditional strategy, as it has always pursued both objectives; in late 2012 it went one step further by formally setting an unemployment target of below 7%. Such a strategy is impossible to imagine in Europe for well known reasons. And it is not clear that such a strategy would be useful, as the ECB's problem is the difficulty of pursuing a single monetary policy and the need to make the monetary multiplier work for such a diverse area that is lacking internal mobility. There is no technical agreement about this, as many economists recall Lucas' famous criticism of using a single tool for multiple contradictory objectives; and there are reasonable operational doubts about how this could be applied when the unemployment rate varies by over 15 percentage points among Euro Area countries. Blindly copying is not an appropriate policy technique, and fashions in economics are just as ephemeral as they are in everyday life.

Target2 is the main Eurozone payment system. It is a real-time gross settlement system belonging to the Eurosystem of central banks, as explained by Javier Alonso and Carlos Conesa[11] from the vantage point of their experience and positions.

It quickly became obvious that the implementation of monetary union would require liquidity to be able to move freely, rapidly and at low cost within the Euro Area, in order to avoid interbank interest rates varying throughout the EMU for reasons other than credit risk and private banking strategies. In 1995 the Board of the European Monetary Institute decided to develop its own payments system, which it called Target. This is a voluntary public system operating in competition with current and future private systems. Until 2008, it was a decentralised system connecting the various national systems. However, it soon became apparent that financial institutions required total harmonisation of services and prices to enable them to have true single treasuries and to benefit fully from the economies of scale of European integration. This resulted in Target2 in May 2008. Despite being a decentralised system, with each central bank retaining its own independent real-time gross settlement system, they share a technical platform operated centrally by the central banks of Germany, Italy and France in the name of the Eurosystem.

Target2 is obligatory for monetary policy operations and for settlement of net systems for large payments. In terms of price and security, it is also the usual channel for high-value interbank transfers and for channelling urgent transfers by participants' customers. As it is a real-time gross settlement system, it eliminates virtually all credit risk for participants. Only central banks are exposed to a degree of intra-day credit risk by providing liquidity (always collateralised) to participants.

[11] Of the Bank of Spain's Settlement Systems Analysis Division.

In 2011, the number of payments managed and not settled represented just 0.18% of all transactions, involving 90 million transactions worth 612 billion euros. Target2 settles an amount equivalent to the GDP of the Eurozone every three or four days. The mean value of a Target2 payment is 6.8 million euros, but the median is just 12,000 euros. Interbank transactions account for 40% of traffic, but 94% of the amounts processed, with the remainder being customer transactions.

Our authors argue that there can be little doubt in the assessment of the Target2 system, that it has "successfully met the object for which it was created... and the national segmentation of the euro-area interbank market that is currently developing is due to reasons other than the functioning of this system". However, there can also be no doubt that the accumulation of balances between national central banks and the persistence of large creditor positions in core countries and large debtor positions in periphery countries is stressing the payment system to unimaginable limits. Hans Werner Sinn[12], one of the five German wise men on the Chancellor's Council of Experts, has sparked a debate in Germany by publically suggesting the Bundesbank should compel other Eurosystem national central banks to make provisions for these debtor positions. This is complete regulatory nonsense that only reflects his personal conviction that the euro -which he never thought a good idea- has failed, and that it would be a good thing for the German central bank to recognise its losses.

But the reality is very different. Monetary union in the private financial system has been in quarantine for many months. Eurozone monetary flows have been renationalised and *cross-border* funding has disappeared or become a rarity. European banks have used long-term funding from the European Central Bank, the so-called *LTRO,* exclusively to fund their national Treasury in the case of peripheral countries with government deficit problems, or to re-deposit the funds with the ECB to ensure they meet liquidity ratios, in the case of core countries.

*[12] Sinn and Wollmershaeuser, Target Loans, Current Account Balances and Capital Flows: The ECB's Rescue Facility, NBER WP N° 17626, November 2011.*

Non-domestic European banks have used this extraordinary official liquidity to sell their bond holdings in countries subject to Troika rescue packages and get out of the country. This is logical, practically compulsory, behaviour for any responsible fund manager: but it is a textbook example of the collective action problems created by Monetary Union. This is particularly true because this behaviour was not just a rational response from bankers to a potential "credit event", it was also induced, provoked and precipitated by their own domestic regulators. In a Monetary Union with as many regulators as countries, not only does country risk not necessarily disappear or lessen, it may actually be amplified by the protective actions of each sovereign regulator on their own domestic banks. The fundamental statutory concern of the German supervisor, BaFin, is not to safeguard the euro; its job is to ensure the stability of the German financial system and the solvency of its banks.

And this leads the Bundesbank and the BaFin to induce its banks to get out of Greece or to sell Spanish debt. This is rational behaviour from a national perspective, but is suicide from that of Monetary Union. The Eurozone has developed a serious problem of incompatible incentives.

When the only real source of liquidity in periphery countries has been the ECB, the debtor position of the Bank of Spain with the Bundesbank, for example, in the European central bank system (Target2) can only continue to grow, and is interpreted unanimously as an indicator of vulnerability in a vicious circle of declining confidence in the single currency. But as Alonso and Conesa argue, the persistence of significant balances in intra-system accounts among Target2 central banks just reflects historic balance of payments performance.

They result from payment transactions by respective participating institutions that have been obliged to recur to a Eurosystem loan given the disappearance of the cross-border interbank market. Furthermore, "the risk run by the Bundesbank with the intra-euro system balance is analogous to the usual risk that the Bundesbank runs in making a monetary policy transaction locally with a German counterparty, enjoying "the same collateral". And if I might permit myself to add a little clarifying provocation: nobody in the United States is the least bit concerned about the debtor position of the New York Federal Reserve with its Kansas counterparty; and nobody in Spain was ever concerned about Galicia's creditor position with Catalonia. But they are in Germany, Holland or Finland with Spain or Italy, and they make suicidal declarations about the need to make provisions against this exposure in a sort of self-fulfilling prophecy of collective madness. This caution only reflects a lack of faith in the future of the single currency; and only serves to question its irreversibility. Perhaps there are some who would like to confuse such desires with reality, because if we Europeans are not clear about our ideas, who is going to trust us? Fortunately, the situation has improved since the summer, and nobody in the Bundesbank picked up the gauntlet thrown down by this "wise man" and enemy of the euro. The launch of banking union is a resounding response to this problem of inconsistent objectives: since its launch, with no need to wait until it is effectively functioning, we already have a de facto common regulator to avoid self-destructive actions by national central banks. This obliges us to consider Target2 balances for what they really are: expressions of the free circulation of capital in the Eurozone, and evidence that this is a single monetary area that is going to be preserved.

Manuel Conthe is a particularly well-qualified analyst to write on Treaty reform. He was involved in the Maastricht negotiations and can provide an interpretation of both the letter and the spirit of what was agreed there: the will of the legislator.

His description of the specific ailments of the euro underlines some of its lesser-known weaknesses. In particular, he discusses the absence of effective collective mechanisms to: avoid the accumulation of macroeconomic imbalances and funding vulnerabilities; enforce the cleanup of government finances during the good times; and preserve the funding capabilities of Member States during crises.

He is particularly critical of some of the political factors in the negotiations. The Germans insisted on the Treaty including a non-joint responsibility clause for national debt, which was "mistakenly termed *no bail-out*", as this implied that the debts of any State did not have an implicit guarantee from the Union or other Member States, but it did not impede these from acting voluntarily to help the State in difficulties. Furthermore, it did not grant the ECB banking supervision functions, but it permitted the Council of Ministers unanimously, on consultation with the ECB, to do this; thankfully, some twenty years later they have done so. But Germany did not get everything wrong. It always argued that monetary union would not be viable in the long term without political union. And as proof of its commitment, it generously accepted one-member, one-vote[13] for ECB governance bodies; this could be interpreted as a commitment to the idea of a Federal Europe. It has had transcendental consequences in the development of the European crisis, as it permitted President Draghi to approve the OMT debt-purchase programme with just one vote against, the Bundesbank.

The author allows himself a brief digression on Spain. Conthe argues that "from a historical perspective, it seems clear that Spain was not ready to enter the euro, despite complying with what were known as the convergence criteria in 1997".

[13] This rule may appear democratically obvious, but it is by no means normal in multilateral financial institutions, such as the IMF, the World Bank and the IDB, which are governed by the principle one-dollar, one vote. And it is also not that obvious when you consider that it gives a country such as Malta the same decision making weight as Germany, whose population, not to mention GDP, is 200 times higher.

I do not wish to let pass a statement with which I do not agree: that most Eurozone economies, not just Spain, lacked the flexibility required to adapt to the monetary corset implied by union with Germany (although the author made this comment in a different context). It has never been a secret that Europe is not an optimal currency area: this has been known since the outset, and we discussed it in our previous report. However, whether Spain is further from the ideal with regard Germany than Italy, Belgium or even France is a very different question. This would not appear to be the case, if we judge by the capacity to respond to the crisis, speed of balance of payments adjustment, labour costs, fiscal rules or social protection systems. Spain suffered -and continues to suffer- a crisis typical of an emerging economy when it fixes its exchange rate: substantial initial credit growth causing a growth spurt with an unhappy ending in a bubble which, if appropriate corrective measures are not taken, pops with high costs. Just because fiscal policy failed by mistaking transitory rent from a real-estate boom for permanent tax revenues, or financial supervision and regulation policy failed due to a mixture of passivity, complacency, political compromises and a lack of European disciplinary mechanisms, or because it failed due to a lack of political courage for structural reform, does not mean Spain was not ready for Monetary Union.

If we follow this logic, no European country was ready and EMU would never have been launched, and should never have been approved. But the logic of European construction, as our author well knows, has always consisted of "putting the cart before the horse", in forcing the situation. In the 1990s, it was argued that an optimal currency area was an endogenous question, that it was a road that had to be travelled, as it had been with trade integration, causing massive displacement of trade with our traditional trading partners on integration into the European Union in the 1980s. And this is what is happening now with financial integration, with banking union, which -excessively quickly and at a cost that is excessively high, perhaps- is producing unprecedented levels of economic, financial and fiscal integration.

Because the Germans were right from the outset, although in these times of nationalist clamour it is now difficult to recognise this: monetary union is a journey with only two possible destinations - political integration or disaster. Perhaps the British were the ones who really understood this from the word go, and that is why they stayed on the sidelines. But they also still believed in their *Commonwealth* and they are beginning to weigh the costs of their decision.

Conthe also highlights an interesting paradox: the response to the crisis has developed along two parallel tracks: measures to reinforce economic union and harsh adjustment measures. Progress has been more rapid on the former, perhaps because political and economic logic makes it possible to stretch these out over time, separating the decision from the effects, though they are controversial in the creditor countries that will have to pick up the tab for mutualisation. Much remains to be done on the latter, precisely because they have an immediate and visible effect for the public and are difficult in a democratic political system[14]. But in the end, he remains optimistic: these are understandable bumps on the irreversible route towards economic and political union in Europe. There will be a banking union, although this will only be complete when the supervisor and the resolution authority are backed by a European Deposit Guarantee Fund. It is probable that a Single Fiscal Authority will be created, a first step -because the order in which things are done changes the product- towards the issue of bonds in the Union (an issue we will return to later). But this requires a new political and institutional approach to restore lost confidence and to avoid abandoning the adjustment and reform effort prematurely.

[14] A result that is not at all surprising or exclusive to Europe, contrary to the general opinion. This is illustrated by the "fiscal cliff" in the USA, which highlights the difficulties for representative democracies in developed countries to manage adjustments to the changing global scenario caused by the rise of emerging economies. This is because there is a deeper crisis underlying both the euro crisis and the US fiscal cliff: the need to redefine the social compact, the welfare model in industrialised countries since the 1920s, which is being called into question by their loss of competitiveness in a globalising world.

Two of our articles address Fiscal Union: these are different but complementary. José Manuel Campa[15] discusses the path to a European Treasury, whilst Pedro Antonio Merino[16] deals with the need to adapt fiscal rules in the Monetary Union. Campa argues for a European Treasury as a mechanism needed for Eurozone sustainability, fiscal coordination and, if necessary, mutualisation. He does this from a functional, rather than ideological or political, perspective. He is not concerned with sharing or rejecting a federal European project, which can be evaluated from multiple complementary, and even contradictory, viewpoints, but rather with "greater fiscal integration being an absolute priority for the functioning of monetary union". He limits this priority to the creation of an instrument for financing the Eurozone as a whole, over which the ECB would have absolute (legal and popular) legitimacy for intervention. This limitation is in my opinion debatable, although I believe that he argues for this simplified approach only for reasons of political opportunity.

European Monetary Union is not a system of fixed exchange rates, and therefore the fiscal mutualisation of obligations within the Eurozone has been inherent to the single currency since its inception. This is implicit in the distribution of ECB costs and profits, something we economists call a "quasi-fiscal cost". The question is therefore how we progress in this mutualisation, not whether it is compatible or appropriate under the Treaties: this is an obvious question that is often overlooked in a political debate that often seems to be seeking to backtrack along the path already travelled.

States with their own monetary policy have a lender of last resort, a central bank empowered to carry national Treasury debt on its balance sheet. This is the case -perhaps excessively- with the Federal Reserve, the Bank of England and the Bank of Japan, and others. In the EMU, the ECB would appear de facto to have this role. But its legitimacy has been put into question by the crisis, questioning the solvency of public borrowers and existing financial instruments. Financial instruments are therefore needed that eliminate the sources of this lack of confidence. These are not, and cannot be, the sovereign bonds of Member States because, ignoring for the moment their greater or lesser solvency at any particular time, they are asymmetric instruments involving biased and self-defeating mutualisation. This is a crucial point. A European asset is required to instrument a common monetary policy . To date, these assets have been the different sovereign bonds of Member States. But these are not a single asset -spreads have widened beyond all rational levels for an irreversible union and are extremely volatile, meaning the monetary multiplier is not working- and neither are they risk free. Furthermore, the ECB does not seem fully empowered to accumulate them on its balance sheet.

As I have already stated, the approach of this article is more pragmatic than analytic[17], probably due to the author's personal experience. For this reason, it limits the initial idea of a European Treasury to the creation of a risk-free liquid financial asset. Such an asset would have to meet the following demanding conditions: (i) sufficient liquidity and depth, as suitable for the largest monetary area in the world; (ii) ample references along all stretches of the curve; (iii) traded in active markets, so market makers would need to be considered;

[15] Professor at the IESE and former Secretary of State for the Economy.

[16] State Economist on leave of absence and Head of the Research Department of Repsol.

[17] However, this approach does not stop us reviewing the five types of European bonds proposed to date that have generated some interest in the European debate: Hellwig and Philippon's *eurobills*, Delpla and Weizsäcker's *red and blue bonds*, the *debt redemption fund* of the German council of economic experts, the *safe bonds* proposed by Brunnermeier et al and the European Commission's *Stability Fund*. This analysis concludes that none of these proposals meet all of the conditions required of a European financial instrument.

(iv) short-term availability for existing -not just future- debt, as this is a necessary condition for getting out of the crisis; and (v) issuance must not be subject to approval by National Parliaments, and must be the exclusive competence of a European Treasury. Such a Treasury would not be a substitute for the many existing European bond-issuing institutions - the European Investment Bank, the European Financial Stability Facility, the new European Stability Mechanism and the Commission itself- as its issues would be justified exclusively for specific, specialist ends, and they are potentially limited in size. I fully agree with Campa that the ESM, in which many analysts have placed such great hopes, does not have the potential to develop into a Treasury issuing the European financial asset. This is not solely because it is an instrument for stabilisation and structural adjustment and its bond issues are limited and have a specific purpose, but mainly because, in my opinion, a crisis management mechanism -a kind of European Monetary Fund- does not, should not and never will have the *expertise,* credibility and political legitimacy to become the basic issuer of Eurozone monetary policy instruments.

His approach, which we describe as pragmatic, leads the author of this chapter to argue that "the function of capturing funds for governments and the use it is decided to make of these, being an essential function of fiscal policy, now has a secondary character because the availability of such a European asset is the absolute priority of creating a European Treasury". Nevertheless, this statement does not stop him from analysing, however briefly, the sources of funds for issuances by such a European Treasury. There are three options: a European tax collected by a supranational authority, a European Tax Authority; a tax coordinated and collected nationally, today's VAT; or contributions set based on national budgets.

Campa does not commit to any of these, but rather argues for an emergency, effective and direct short-term solution: giving priority to interest and debt payments on joint issues of such European assets in national budgets. Such a solution would give holders of these new assets the status of preferential creditors of all euro Member States. This in an original solution, but in my opinion it is insufficient, as:
(i) it only postpones serious political decisions, with experience showing that the truly transcendental decisions are only being taken at times of crisis. I fear that once the urgency disappears, we would relapse into complacency and inability to agree; (ii) it would not give the European bond the credibility it needs, because who can guarantee, and how, that at times of economic crisis -which is what we are really talking about- the same national parliament that approved it would not alter its priority; (3) it ensures there will be extensive legal wrangling, because when a holder wants to exercise their collection rights, which government would they address first? And why would this government agree to honour this presumed obligation rather than entering into interminable discussions with its European partners?

The article also considers the possible uses the funds raised by a new European Treasury could be put to. These range from funding national budgets based on previously agreed shares to the management of monetary and financial union. Of these, Campa favours the creation of common contingency funds to support banking union and to act as automatic fiscal stabilisers. Using funds from the issue of a new class of risk-free, liquid European asset -a requirement for a single monetary policy- to create a permanent stabilisation fund seems a reasonable proposal that would bring the EMU closer to being an optimal currency area.

In my opinion, one of Europe's main woes is precisely this lack of decisiveness in resolving problems when they arise.

This opinion is shared by most international observers and investors. Campa has defined the problem very clearly. But a definitive solution is required. A lot of time has already been lost, and the crisis has been prolonged and worsened by playing for time. I fear that creating a European Treasury will involve much more than just issuing a safe and risk-free European asset, but it is a task that is both urgent and complex.
And I do not see how we can avoid deciding how the European Treasury would be funded, the competences it would have, and under which European authority it would be established, not to mention how we progress on Fiscal Union.

I have written on a number of occasions[18] that Fiscal Union does not imply full tax harmonisation: rather, it simply involves avoiding and internalising the externalities, both positive and negative, that arise in such a union due to the legitimate exercise by Member States of untransferred sovereignty. In its strictest sense, Fiscal Union requires three things: rules of behaviour, decision making mechanisms in the event of non-compliance and an Administration to implement these. Despite the apparent scope for conflict, establishing the rules of behaviour is technically the simplest part. All that is required are simple pre-agreed rules on deficits, debt and nominal expenditure. Everything else can and should continue to be the competence of national governments, and a legitimate way of competing strategically through a national mix of public and private goods in an area with free movement of capital and labour. We will return to rules and compliance later, following some discussion of the European Fiscal Administration. The Greek crisis has made it obvious that monetary union cannot continue to operate without reliable, real-time, fiscal information. The official response has been to establish extraordinary fiscal reporting and disclosure mechanisms in countries subject to rescue programmes.

But a lasting economic union cannot be built on exceptional mechanisms for members who are under suspicion: permanent mechanisms are required. I do not see any alternative to creating an embryonic European fiscal administration, with full inspection powers and competences to examine and audit national accounts. Our experience of fiscal supervision in the Euro Area leaves much to be desired. Even with the entry into force of the new fiscal compact, current fiscal-supervision mechanisms are insufficient. This would be the prime role of what has been, poorly, termed a European "super"-Commissioner for the Treasury[19].

Antonio Merino analyses fiscal rules from three perspectives: analytically, reviewing the academic literature; descriptively, setting out the various rules that the European Union has, with greater or lesser success, set for itself; and based on the proposals made. He opts for a Hamiltonian solution[20] in which a central European authority would assume full or partial responsibility for Member State debt. Fiscal rules have arisen to give credibility to fiscal policy irrespective of the political cycle. They have their typical origins in emerging economies, where weak institutional frameworks make them easy prey for the speculative cycles coinciding with elections. However, because of its founding characteristics, fiscal rules in the European Monetary Union "perform a radically different function, stopping fiscal policies, which continue to be national, interfering with the operations of the single monetary policy". They are to a certain extent a necessary substitute in the absence of a European Treasury; it could be argued that they will disappear when such a Treasury is created[21].

[18] Most recently in the November 2012 article cited at the start of this Executive Summary.

[19] The "super"-Commissioner is poorly named because they would only have competences over Eurozone countries: such a role could not be a Union Commissioner, but would be limited to the

[20] By analogy with the United States in 1790 when, following the American Revolutionary War, the Union's then Treasury Secretary, Alexander Hamilton, decided to fund the debt of all federated States.

[21] An extreme case in which political integration develops to such an extent that all externalities associated with national policies disappear: this is not very realistic in a federation of sovereign states, which is what the Eurozone seems to aspire to being.

A fiscal rule imposes a long-term quantitative restriction on one or more budget elements, such as the total balance, nominal expenditure, percentage revenue as a share of GDP, stock of debt, etc. Over time, such rules have become more complex as they try to combine stability and sustainability objectives for the public accounts -the initial objectives- with the flexibility to respond to shocks. This is reflected in the definition of structural rather than nominal targets. The development of the European rule is a good example of this. The Stability and Growth Pact was initially set in absolute terms -the famous deficit of 3% of GDP. This was subsequently revised in the European Stability, Coordination and Governance Treaty, requiring the structural public account deficit to be less than 0.5% of GDP. This it must be recognised is in line with the International Monetary Fund's recent doctrinal contributions.

I am completely and openly against this development for reasons that I have repeatedly stated[22]; however, I fear this is a battle that has unfortunately been lost.

All that remains is to ask the politicians responsible, and the economists advising them, to reduce the degree of discretionality in the application of these structural rules by defining them precisely. An European protocol for measurement of the structural deficit is urgently required. I am fully aware that this would be just one more European convention, similar to the accounting conventions used to define core capital in Basel III and the EBA. There is no single or unanimously accepted definition of what the structural deficit is. And there never could be, as it is a gelatinous concept. However, a precise and unambiguous European legal definition is required that enables any informed observer to calculate and understand this for all Eurozone countries, without waiting for a proclamation from the Commission or Eurogroup. The transparency of a fiscal rule is as important as the rule itself. This is not about creating economic science; it is only about having a well-understood and predictable European fiscal policy or providing legality and legitimacy to the supranational or multinational (this is another major issue) political authorities responsible for applying it.

Fiscal rules have gone from being an esoteric concept to being commonplace in just a few years. Nobody would now argue against the need for such rules to ensure that European monetary union functions correctly; they have now moved on to discussing the technical details. This is evidence of the maturity of the European project. Since the summer of 2012, such rules have been given greater legality through incorporation into national constitutions or regulations of similar stature, thus simply -and this is no small matter- raising the political cost of not complying with them.

[22] I set out my reasons for the Anglo-Saxon approach known as *kiss - "keep it simple sweetie"* - in both the Fundación's first report on the euro in 2011 and in my aforementioned 2012 study. These can be summed up as avoiding policy discretionality and legitimacy deficits in an issue as unpopular and polemical as the imposition of restrictions and potential sanctions on the fiscal sovereignty of national parliaments. I offer the following lengthy quote for those who may be interested: "The latest European trend, quite unsurprisingly based on the work of the IMF under the academic leadership of Blanchard, is to move towards structural deficit rules that take into account the cyclical behaviour of economies and permit fiscal policy to be used beyond automatic stabilisers. I consider it to be a frequent and manifest error, an example of a lack of awareness of the basic principles of political economy and the bureaucratic taste for enlightened "arbitrism". It was exactly this political philosophy which killed off the Stability and Growth Pact in 2003 after violations of it by France and Germany. There will always be good economists, and better politicians, willing to justify any deficit for a good cause. Complex rules, which are hard and not straightforward to interpret, only mean there is more elbow room for political negotiation and eroding European legitimacy; because there is no doubt that they unleash discriminatory tensions among the different countries and accusations of unequal treatment. We are already seeing this.

Yet the fact is that there are also purely technical reasons that advise against cyclical rules. Put in no uncertain terms, potential global investors, who are ultimately destined to fund these deficits, might not endorse these same cycles. What needs to be funded is the current deficit, not the cyclically adjusted one, and this could prove too much for the willingness to help and the risk appetite of investors: tell Spain or Portugal about it! If they are being consistent, those in favour of cyclical rules ought to be defending rising levels of government debt in the various European countries and certainly the immediate introduction of Eurozone-backed Eurobonds", F. Fernández, op cit 2012.

The new European legality that has arisen in response to the crisis also includes: (i) a procedure for implementation of the agreed rule, known as the excessive deficit procedure and the reverse majority rule; (ii) an external supervision mechanism for national governments through the creation of independent Fiscal Councils and the ultimate participation of the European Parliament; and (iii) automatic correction mechanisms, action protocols that are activated automatically in the event of non-compliance to avoid ad-hoc political disputes. This evolution is all very positive, but as Merino forcefully concludes, and I partially agree "a federal approach is needed creating a central executive arm with the capacity to impose taxes and to perform a stabilisation function in the event of shocks".

I agree that the Eurozone needs a central, federal stabilisation function, particularly because in other monetary unions, notably the United States, this stabilising function is shared between the federal budget and internal migrations, a balancing factor that for obvious reasons can never aspire to playing or coming remotely close to the same role in Europe. However, I do not consider that this function requires tax-raising powers. I think it would be more than sufficient for this federal power to have the undisputed power to set a ceiling for nominal expenditure, the current deficit and public debt in each country. This power must be undisputed and apply to all Member States, and not subject to ad-hoc negotiations; it should not just apply exceptionally on, a temporary basis, during an excessive deficit procedure. However, this is not true of tax-raising powers, precisely because in a federation of sovereign states, which is the Eurozone's goal, national governments have to retain their ability to choose the appropriate combination of public expenditure and revenues, subject to some shared minimums, in accordance with their preferences and the wishes of their electorates.

Contrary to the position of the author of this chapter, I see no need to equalise social welfare levels or labour market legislation. Firstly, there is no real possibility of this occurring, and we must not continue stoking the recurring temptation to promise and then fail to deliver. But neither is there any technical need for this. European Monetary Union can work perfectly well with national differences. I believe that it can only work correctly if there are differing national public revenues and expenditure, precisely because the economic structures in these countries are very different and they cannot be improvised or modified in a rush of Europhile enthusiasm. This is what I have termed European "arbitrism". I believe this to be as serious an obstacle to European integration as the euro-sceptics. To put it plainly, a service economy such as Spain cannot compete internationally under the same tax rates and structures as an industrial economy such as Germany. Irrespective of how much our beloved and well-intentioned "arbitrists" try, Spain is not going to be a similar industrial power for decades. And it will never be if it does not first copy many other things from Germany before its financial system, which is expensive, inefficient and not very competitive; its tax structure, which penalises consumption and domestic expenditure; or its industrial democracy model, which is of debatable effectiveness and gives little scope for the productive flexibility required at a time of economic globalisation. I would encourage the reader to consider Merino's article and draw their own conclusions on what is, we both agree, a key issue for the future of Europe.

The final two articles in this report address banking union, but from very different perspectives. Francisco Uría[23] analyses European banking supervision and resolution as an object in a state of flux, a construction process that seems to be approaching its final design.

[23] State Attorney on leave of absence, and KPMG partner responsible for the financial sector.

[24] From Clifford Chance.

José Guardo and María Luisa Alonso[24] focus on the private aspects of the new European Banking resolution framework and the changes in rights for creditors and shareholders resulting from the new restructuring and liquidation framework for credit institutions included de facto in the Memorandum of Understanding on financial sector policy signed by Spain and the Eurogroup on 20 July 2012, which inspired Law 9/2012, of 14 November.

Uría's article reviews progress on the financial integration process in the Euro Area since the outbreak of the financial crisis. It concludes that there have been significant changes. These have been evident since 2009 but accelerated in summer 2012, when there was a real sea change in the opinions of European leaders on banking union. In general, I fully agree with this assessment. This unification process has already suffered, and will continue to suffer the inevitable delays of European construction. But this is a radical and highly beneficial change for the sustainability of Monetary Union, although it may result in Spain suffering temporary funding problems for its bank restructuring. "New institutions have emerged that are responsible for macro and micro prudential supervision... this is a decisive step forward in the construction of an authentic European financial sector... institutions without which European banks will not be able to compete effectively with the major international banks... these represent a major advance in the construction of a true single market in financial services".

The author considers this to be a process in which the European Commission, despite all the criticism it has received, has shown great political courage and excellent technical capabilities by putting specific proposals on the table that have become not just a roadmap to banking union, but also, on many occasions, they have headed off expected political pressures and seized the initiative from national leaders. This is strong backing for the Commission, and is also a decisive vote of confidence in community procedures and in defence of supranational authorities, despite the evident inter-state temptations that influence many governments. Through this statement, Uría is taking sides in a political debate that is latent in all the apparently highly-complex technical discussions comprehensible only to initiates of the integration process, the need to reinforce community procedures as much as possible and to avoid the temptation to rely excessively on new international agreements within the European Union. This opinion is by no means insignificant and underlies this whole study. I believe that all of our authors would find no difficulty in agreeing.

The author of this chapter starts by reminding us of the steps taken at the European level for the prevention and resolution of banking crises, from the creation of the European System of Financial Supervisors (ESFS) and the European Systemic Risk Board (ESRB)[25] to the European Banking Authority (EBA), which, from the resources assigned to it and the nature of its functions, it is clear was never conceived as anything more than a coordination instrument for national supervisors. This instrument has become a little more refined and permanent, and less opportunist, than the previous supervisors of transnational banks, overcoming confidentiality problems in information exchanges. But the system remains based on the competences of national regulators.

One of the fundamental tasks assigned to the EBA is to develop consistent supervisory practices, known as the *Single Rule Book,* for the whole European Union, not just the EMU. This is a curious task given that it coincided with the G20 assigning, with strong European pressure, the Basel Committee on Banking Supervision to prepare such principles on a worldwide scale. This process resulted in the "Core Principles for Effective Banking Supervision", sent out for comments in December 2011.

[25] Approved by Regulation (EU) 09, 2010, of the European Parliament and the Council of 24 November, creating what are known as the three European Supervisory Authorities (ESAs): the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority.

The author is right to underline the importance of this document for the European supervisory model, including issues such as treatment of systemic banks; the macro-system perspective; recovery facilities and resolution measures; and good corporate governance issues. However, in my opinion it is also true that this dual process reflects a latent risk that is not always clearly addressed in Europe: the need to make progress in parallel on European integration and international coordination on banking supervision and regulation and the need to avoid a potential counterproductive head-on-collision between the juggernauts of *strong* regulation, North America and Europe. This is the traditional Fortress Europe temptation that never quite disappears.

But banking union involves much more than shared culture and supervisory practices. Today it implies three things[26]: a single European banking supervisor, a restructuring and liquidation mechanism -which we are now calling resolution in the softer Anglo-Saxon terminology- and a European Deposit Guarantee Scheme. The Eurozone has not taken long, in relative terms, to realise that its original approach to supervision based on increasing coordination between national authorities was doomed to failure. It has now been replaced by a federal approach, granting the ECB specific supervision competences, and recognising the unquestionable fact that only the ECB has an institutional structure capable of successfully supporting a rapid transition to a single European banking supervision authority[27].

This is a federal approach at the heart of the Eurozone, with the ECB at its epicentre. It has to be consistent with all other European Union banking systems -particularly the British system, for obvious reasons- being comfortable with guaranteeing the Single Financial Market, and with separation of monetary policy and supervision functions in the new ECB. This structure will be funded by a future European tax on credit institutions to fund supervision activities.

Much has been said about the single supervisor not being launched until well into 2014, and that there will be certain restrictions upon it that, as described in the article we are discussing, exclude a large part of the German banking system. However, Uría finds these debates to be somewhat superficial as, once it is operating, the weight of the European supervisor will eventually impose itself, and purely local institutions will always be supervised locally. This is true but, in my opinion, it is not the most relevant question. I believe the real question to be who will ultimately decide, who will apply the common criteria and who will interpret any discrepancies, whether between the institution and the supervisor, or between local and European supervisors. In my opinion it is neither irrelevant nor less important that the European procedure finally introduced should exclude any possibility of *regulatory forbearance* for particular national institutions, as we have seen excessively during certain episodes of this crisis.

Two clearly complementary directions have been taken in crisis prevention, management and resolution procedures. Firstly, on 6 June 2012 the European Commission submitted a Proposed Directive to the European Parliament and the Council to establish a framework for the rescue and resolution of credit institutions and investment companies[28] ;

[26] This is not in doubt following the European Commission document and Eurogroup agreement of June 2012, but this was not the case when proposed by Fernández y Navarrete (2009), *La Reforma del Sistema Financiero Internacional (Reform of the International Financial System),* Faes, Madrid, or even in December 2011 when the Fundación de Estudios Financieros published its first report on the euro.

[27] This recognition has not been unanimous, as the Bundesbank's reticence is well known; this is because its national structure does not include this supervisory power, which rests with another federal institution, BaFin.

It is however somewhat surprising that its president is still discussing the legal basis for granting the ECB this competence without modifying the Maastricht Treaty. This is surprising because the legal basis is unquestionable, as set out in the articles by Sáinz de Vicuña and Conthe.

and secondly the Memorandum of Understanding signed between the Spanish government and the Eurogroup for recapitalisation of the Spanish banking system, which in practice represents an application of this draft Directive before it has fully ripened. Both of these documents are well known and have been exhaustively analysed[29]. In his article, Francisco Uría highlights that: (i) they establish an alternative administrative procedure for bank resolution to that of ordinary commercial procedures; (ii) they confer extraordinary powers on bank resolution authorities so that they cannot be blocked by the ordinary administrators of banks that have been wound up; and (iii) they define a procedure for the distribution of costs between shareholders and creditors -the famous *burden-sharing,-* that aims to make two potentially incompatible objectives compatible: to protect the rights of investors and to minimise the cost to the taxpayer. This controversial procedure has long been called for by international organisations such as the IMF, but it is an innovation in Europe. The Directive and the Memorandum of Understanding take a qualitative step forward towards banking union by creating an authentic federal European resolution system, which is bound to lead to the mutualisation of any future bank restructuring costs among all European taxpayers.

A separate question -and of particular importance for Spain- is whether the application of this new procedure when it comes into effect will involve the mutualisation of Spanish bank debt, and the assumption by the new Resolution Authority of the recapitalisation costs of the Spanish banking system from the second half of 2012.

Many, often contradictory, positions have been taken in this regard by the agents involved, ranging from national governments to community bodies. But I am convinced that the many arguments based on justice -how can he who calls the tunes not pay?- and efficiency -what is the point of launching a European procedure that will not be applied unless Monetary Union has ruptured?- make this inevitable. We set this out in our first report, saying that some kind of European sharing of bank risk would ultimately be needed to resolve the current euro crisis. We still believe this, and events are proving us right: for example, through the restructuring of Greek debt in official and public hands, and the joint bearing of the cost by European taxpayers.

The third leg of banking union -where it is obvious the least progress has been made- is in the creation of a European Deposit Guarantee Scheme. In fact, we seem to have gone into reverse between the initial Eurogroup position in June, when the launch of this European insurance was presented as a necessary component of banking union, and the Council meeting in December when all reference to it had disappeared. Although Uría does not say as much, I believe he would agree with my position that this is but a tactical withdrawal motivated by the well-known electoral pressures on core Eurozone countries. I remain convinced that this is a core element for the survival of Monetary Union[30]. Without this, capital controls within the Eurozone will become inevitable, divergences in Target2 balances will become potentially explosive and it will become almost inevitable that a government will unilaterally default on its European commitments.

[28] Draft Directive framing Royal Decree-Law 24/2012, of 31 August, on Bank Resolution and Restructuring, and the resulting Law 9/2012, of 14 November.

[29] In particular, *The Financial Sector Adjustment Programme for Spain,* in European Economy, Occasional Paper 118, October 2012, and *Spain: Financial Sector Reform-First Progress* Report, IMF Country Report 12/318, November 2012

[30] This is not the place to explore in detail the arguments for the need of a European Deposit Guarantee Fund. For this, I would refer the reader to my recent study previously cited as Fernández 2012, which deals with this in depth and makes specific proposals on what should be implemented and how.

As this is a tragic outcome for a minor issue, having gone so far in all other aspects, it seems more of a symbolic postponement, a diplomatic oversight. Why? What could be the point of refusing to pool bank risk once fiscal union has mutualised pure fiscal risk to the taxpayer and, through the single supervisor, the "quasi-fiscal" risk implicit in central bank losses?

The final article in this report aims to explain to non-specialists the consequences of legislative action to achieve greater European financial integration for relationships between private citizens. We thought it important in this second report to go beyond macroeconomic analysis of certain aspects of the crisis and banking union, and to examine the implications for shareholders, creditors and private debtors. Guardo and Alonso, the authors of this chapter, do not beat around the bush. New European legislation defines an intervention regime for credit institutions that "in practice involves depriving the creditors of such commercial companies of their protection and rights under bankruptcy law, whilst enshrining a range of extravagant powers to public authorities to the detriment of the rights of shareholders, administrators, holders of hybrid instruments and other stakeholders in these institutions". Their opinion is no doubt controversial and should be balanced against the desire of the authorities to avoid systemic crises and the need of States for effective tools to prevent and resolve such crises in a timely fashion and at the lowest possible cost to the taxpayer, the real lender of last resort. It is difficult to say, and arguable, whether the fledgling European legislation has achieved a fair balance. Indeed, I do not share the opinion of our authors on this, perhaps because we are viewing the issue from very different analytical and professional perspectives. However, we do agree that it is reasonable to expect the approval process for the proposed Directive[31] to provide more detailed answers to the questions raised in this article.

Royal Decree-Law 24/2012 and the subsequent Law 9/2012, which as previously stated incorporate the proposed draft European Directive before it has fully ripened in line with the recommendations of the Basel Committee and IMF Financial Stability Reports, define three types of action in banking crises: early preventive action, recovery and resolution (liquidation) of credit institutions. The first of these actions is justified when the supervisor has a reasonable expectation that the institution cannot meet its solvency, liquidity, organisational structure or internal control requirements, but it could do so without recourse to public funds. This is a true innovation and grants extensive discretion to the supervisor, as they are authorised, de facto, to intervene in an institution and restrict certain behaviours, such as dividend payments and compensation to managers and executives, even when they formally comply with current regulatory requirements at a particular moment in time. The reasoning behind this is obvious: prevention is better than cure. This is based on peerless technical arguments: extending an established aspect of monetary theory -that prevention is always the best policy- to the field of supervision. If we have learnt anything from this crisis, it is that excessive complacency on the part of regulators has increased the cost of the crisis and prolonged its impact. The political justification for this is also obvious: the taxpayers feel they have paid too high a price to clean up the banking sector due to the passivity of the authorities and their capture by the sector.

[31] Draft Directive of the European Parliament and the Council modifying Directives 77/91 EEC and 82/891/EC of the Council, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) 1093/2010. Just reading this list is sufficient in itself to show that the process of repeated patching up has now reached unsupportable, and probably incomprehensive, levels, and that a systematic rethink of the issue, defining a new European consensus, is now urgently needed. This is further emphasised by the lessons -both academic and political- of the crisis.

But the usage and limitations of this discretionality must be carefully monitored: I have been calling for this inevitable and desirable discretionality since 2009, but it must be accompanied by adequate treatment of the regulator's powers, responsibilities and legal protection.

Guardo and Alonso's article addresses the other two potential actions -recovery and resolution- contrasting the two new procedures and the traditional bankruptcy process set out in Law 22/2003, of 9 July. The European Directive establishes that losses should be distributed subject to the principle of the pecking order of shareholders and creditors. It also establishes that creditors in the same category may be treated differently, if this justified in the public interest: the authors consider this to be inconsistent with *"pars conditio creditorum"*, the foundations of Spanish bankruptcy law. And whilst there are major differences in principles, the material differences are even more significant: whilst bankruptcy procedures are subject to the courts, recovery and resolution are administrative procedures, with the Bank of Spain and the Fund for Orderly Bank Restructuring (FROB) being assigned a number of important competences that cannot be appealed against before the Supreme Court's Administrative Court. The authors conclude that "whilst the difficulty of the exercise carried out by Spanish legislators is obvious, we must criticise the lack of precision in regulations that, whilst well-intentioned in their objectives, expropriate rights, and therefore should only be applied under strict and effective control from the courts".

The authors are particularly critical of this, "considering the relatively limited scope for judicial review of such discretionary acts". However, I consider that, as with modern banking legislation throughout the developed world, the nature of banking crises is such that they are incompatible with regulation through general bankruptcy legislation.

This established fact in modern banking supervision and interaction has its roots in the very nature of the banking business itself. A business based solely and exclusively on the confidence of its users. The goods traded -whether money or financial assets- have practically no intrinsic value other than that ascribed to them by the confidence of those involved. It is an extremely volatile business, where the net asset value of an institution can disappear in a matter of days, as we have seen with some of the legendary names in the industry during the crisis. And it is a business where the externalities -the consequences for the rest of the economic system and the quality of life of the public[32]- are immense. It is ultimately, a business that governments throughout history have been obliged to support with public funds. And it is this truth -that the taxpayer ultimately has to come to the aid of banking institutions[33]- that in my opinion justifies granting extraordinary powers to the public authorities for the recovery and resolution of credit institutions. And these administrative powers, special but sharply defined, would be outside ordinary commercial legislation.

This chapter examines in detail the four types of resolution instruments defined by law: sale of the institution's business, directly or indirectly, to a third party; the transfer of its assets and liabilities to a bridge bank; the transfer of assets and liabilities to an asset management company -a so-called "bad bank", although we have argued that these are neither banks nor necessarily bad; and financial support for any of these three approaches.

[32] Consider what a breakdown in a country's payment system would mean as an example of the effects of a systemic crisis.

[33] And remember that in a systemic crisis, there is no such thing as a small or irrelevant financial institution for the banking system as a whole. Both Northern Rock in the UK and Caja Sur in Spain may have appeared small and irrelevant, but their respective governments were compelled to rescue them. Even if only for reasons of political economy: if the rescue turns out not to have been necessary, some of the money can be recovered and it is only a small political blot; but if the government fails to act and a systemic crisis results, the government will not be able to bear the political cost and will fall. Not the most elegant argument, perhaps, but all too real.

In this Executive Summary we only consider the asset management company resulting from bank restructuring because of its newness and relevance for Spain. SAREB was created and came into operation in December 2012. The article is critical of the option of creating a single limited company to absorb every asset class, as: (i) it did not seem that the structures and managers appropriate for handling one asset class would necessarily be appropriate for managing other asset classes; and (ii) it would not be reasonable to expect specialist investors to invest in what we might term a "generalist" company. To deal with this problem, the law permitted SAREB to group assets and liabilities to create separate structures with no legal personality of their own, even though they could hold rights and bonds and have the legal structure of an SIU, similar to that of a "SICAV" securities investment company. This solution may not be ideal, as "experience under foreign regulations shows SICAVs share the same investment policies, and that the difference between their various compartments are mostly just details".

The authors also pay particular attention to measures for the imposition of losses to the holders of hybrid instruments in the regulations. The proliferating use of such instruments -preference shares and subordinated debt- by Spanish financial institutions to meet their capital requirements resulting from the crisis makes reading this section highly recommended[34].

The law obliges institutions being restructured to transfer recovery and resolution costs for these securities rights to their holders, submitting them to a capitalisation or debt-relief agreement, that would, in the last resort, be undertaken by the FROB through an administrative decision that would address "the appropriate distribution of costs" subject to no limitations other than those set out in article 45 of the aforementioned Act. Faced with such a decision, the holders of such instruments may resort to the administrative appeals procedure, which "probably will not consider the appropriateness of the measure imposed, as the holders of hybrid instruments must be able to demonstrate that the probability assessment made by the FROB prior to taking the measures described was mistaken: in other words, that the institution would have been able to reverse the situation through its own resources". A lot of time will have elapsed before the Courts make this judgement, by which time the institution, if it survives, will have changed radically, making it impossible in practice to reverse the situation. In other words, the holders of such hybrid instruments must be aware from the outset that they are really just pleading for compensation, not the reversal of the decision.

Finally, and with an eye on the future, any assessment of the new European regulatory framework for bank recovery and resolution must be made through the prism of international efforts to increase the capital of financial institutions: one of the general conclusions to be remembered from the crisis is that it arose due to the scanty levels of *"loss absorbing capital"* with which financial institutions had been operating since the 1990s. The increased risks imposed on banking creditors by the new regulations will no doubt make this type of funding more expensive. And this may make it more attractive to be a bank shareholder, in relative terms. If this is the objective, or a collateral objective at least, it should be clearly spelled out, because it is apparent that internal and external bank funding is becoming more expensive;

[34] This proliferation had in my opinion been promoted and supported by authorities such as the Ministry of the Economy, the Bank of Spain and the Spanish National Securities Market Commission (CNMV), who saw them as a low-cost way of postponing the moment of reckoning for the real solvency of the financial system, which for too long was considered one of the most robust in the world.

and these increased costs will no doubt be passed on to depositors and borrowers. This is a necessary corollary to the new financial deleveraging processes taking place today throughout the developed world; or perhaps it is the ultimate objective, if the crisis was the result of a credit bubble, and not just in Spain.

## A DECALOGUE OF CONCLUSIONS

We ended the Fundación de Estudios Financieros' first report on the European crisis with ten lessons drawn from the crisis. We would like to repeat this, if somewhat briefly, in this report.

1. Treaty reform is inevitable, but not urgent. If interpreted sufficiently flexibly, the current Treaties are sufficient to launch the mechanisms needed for progress towards banking union. They have proved sufficient for the ECB to act as the lender of last resort, and to assign it supervisory functions for banks. This is significant. However, it is also true that a new European consensus, formally set out in a document constituting the reorganised Monetary Union, will be required for it to have full legal and political legitimacy. The most urgent reform for the ECB involves not itself, but the creation of European fiscal and supervisory bodies with the same federal European nature as the central bank itself. Permanent mechanisms need to be designed urgently to make increasing integration of Eurozone countries fully compatible with the European Union's single market.

2. Rather than being a problem for the Monetary Union, the imbalances in national balance of payments in the Target2 European payments system are rather a sign that the system possesses the mechanisms needed to ensure internal liquidity flows, replacing the lack of appetite of individual investors with official liquidity. However, this is an extraordinary, temporary mechanism that can only replace the private interbank market at times of particular risk aversion. Europe is responsible for resolving the incentive problems among national monetary, supervisory and fiscal authorities that emerged with the crisis, and for re-establishing normal risk conditions to encourage the return of private capital. In particular, this means ending what is known as redenomination risk, i.e. the risk of the breakup of the European monetary area. If it sometimes seems that Europeans themselves do not believe that the euro is irreversible, who else is going to believe this?

3. Decisive progress towards banking, fiscal and political union in the Eurozone will be required to eradicate redenomination risk. Any other solution would only be temporary. No permanent system can be built on the basis of special mechanisms for countries in difficulties, ad-hoc discipline and intervention regimes or conditional special aid programmes. There must be the same rules for all Member States, and the consequences, including sanctions, for non-compliance must be the same.

4. There are three essential requirements for banking union: a single European supervisor for all banks; a European Bank Recovery and Resolution Authority; and a European Deposit Guarantee Scheme. There is no reason why the rate at which these mechanisms are approved and come into effect should coincide, but the ultimate design must be complete and defined from the outset. The parking of creation of a European Deposit Guarantee Scheme by the European Council in December can only be seen as a diplomatic oversight. Any other possibility would make it impossible to trust in the sustainability of the Eurozone.

5. Creation of a European Treasury is an essential step for the sustainability of the Eurozone, fiscal coordination and eventual mutualisation of the public debt of sovereign states that have surrendered the traditional instruments to manage fiscal crises, such as monetary and exchange-rate policies. The first step in creating a European Treasury is the creation of a liquid, risk-free European asset with sufficient depth that it can be used as a monetary policy instrument by the ECB, and to explicitly mutualise the quasi-fiscal risk in the EMU.

6. But the path to fiscal integration does not just involve creating such a financial instrument. The source and use of the funds raised using this asset must also be decided: how it will be funded and how it will be spent are key questions in all fiscal policy. This will represent significant progress towards the creation of a European Stabilisation Fund -a mechanism required for all monetary unions, particularly one where internal migration will always be limited- and towards mutualisation of fiscal risk in the Eurozone.

7. Because EMU will ideally be a federation of sovereign states, the Eurozone will always need a robust fiscal rule to limit and guarantee fiscal solidarity among European taxpayers, as it is essential to avoid national fiscal policies interfering with the operations of the single monetary area. This rule must be flexible and applied automatically. But it must also respect the principle of subsidiarity. Adopting this would create the germ of a European Fiscal Authority, but not full harmonisation of tax systems or public expenditure. In its strictest sense, Fiscal Union only requires three things: rules of behaviour, decision making mechanisms in the event of non-compliance and an Administration to implement these. Nothing more is needed, but nothing less is required.

8. The single supervisor coming into operation in mid-2014 will be a definitive step towards European banking integration. It will be a qualitative step towards construction of an authentic European financial sector, with equal rules for all members, where banks compete for solvency and profits under equal conditions, with no implicit guarantees from their national Treasuries, and the advantages that implies. The one-year delay in the original timetable, and the costs of this for Spain, should not make us lose sight of the immense positive change that will result from replacing an insufficient and exhausted process of reinforced cooperation between national supervisors.

9. The creation of a European Banking Resolution Authority is implicit in the proposed Recovery and Resolution Directive. There is a huge challenge in adapting all national frameworks, bringing into question the existing legal systems established in the legislation of many nations. This will result in a new distribution of rights and duties among shareholders, creditors and taxpayers, modifying rights acquired and well-founded expectations. As with the whole European integration process, this involves building a new consensus on the always difficult issue of distributing the burden of banking crises among participants under the principle of defending taxpayers, who ultimately pay the bill.

10. The Eurozone has moved on from the risk that it might fall apart, but not from the economic crisis. There will be many obstacles on the way, and many reinterpretations of agreements already reached, hard technical battles and political upsets. But the European Monetary Union has made clear its intention to remain firmly in place since the summer of 2012. This decision could only be reversed by a cataclysm. The road will not be easy: it involves distributing the costs of mutualising bank and fiscal risk, and defining an economic policy for the Eurozone, in a model that combines fiscal austerity with solidarity and structural reforms with growth policies. And the people of Europe must be convinced. A lot of education and politics needs to be done.

Fernando Fernández

## POSTSCRIPT

This book had already been printed when the Cypriot crisis exploded and the Eurogroup organised a rescue package that highlighted the problems of governance and crisis management that continue to dog a recovery of confidence in Eurozone economies. The rescue package also takes a significant step forward by making bank creditors and depositors participate in the costs of the systemic crisis. This has been termed a *bail in.* Simon Samuels, a Barclays Bank analyst, has estimated the cost for European banks of higher interest rates to retain uninsured deposits, currently over 100,000 euros, and to pre-fund the now urgent European deposit guarantee scheme at 15 billion euros. In summary, the Cypriot programme involves:

(i) immediately implementing -prior even to formal approval of the proposed European directive on bank resolution- mechanisms through which un-insured deposits contribute to bank recapitalisation, after shareholders and creditors, but before taxpayers;

(ii) anteponer el *bail in* de los depósitos a la puesta en marcha del Esquema Europeo de Garantía de Depósitos. This means that the recapitalisation costs will be treated as national debt to be paid individually by each Member State, even if with a liquidity loan from Europe, which is what the European Stability Mechanism means today. However, there will be no mutualisation of debt existing at the date of the crisis;

(iii) maintaining the illusion that monetary union is sustainable without banking union, and that the imposition of, presumably temporary, capital controls does not represent a rupture in the current Eurozone monetary and exchange structure; that two different types of euro assets have not been created, those inside Cyprus and those outside.

The message sent to investors -no matter how much it has been attempted to present this as a new and exceptional case- was summarised by the *Institute of International Finance* as, in the event of doubt, buy government bonds, don't hold bank deposits. To which I would add, don't even think about buying bank bonds. There are two problems with this decision. On the one hand, it ignores that the order of factors in a banking crisis alters the product, what is known as *sequencing*. In other words, without a European Resolution Authority and a European Deposit Guarantee Fund, punishing bank deposits aggravates the banking crisis-sovereign debt crisis loop, widening spreads between financial institutions because of their nationality and the strength of their sovereign debt, not because of the quality of their balance sheet and risk profile. And on the other hand, it overlooks the fact that in the absence of European deposit insurance, if the size of deposits is impacted, this increases the banks' needs for funding from the market, or aggravates credit restrictions. The first of these makes financial institutions more vulnerable and makes it more difficult for them to fund their activities, resulting in recapitalisation using public funds; the second aggravates the recession, increasing non-performing loans and thus increasing recapitalisation needs.

The form and substance of the Cyprus rescue package has delivered a serious blow to the credibility of the European banking union project. Fortunately, the markets are under the influence of extraordinary liquidity decisions by the central banks of Japan, the UK and the USA, and have not punished these European doubts and wobbles. But vulnerability has nevertheless been increased. Either the Union will be able to recover its reformist momentum and approve a schedule for full banking union, including the three necessary components of supervision resolution and deposit guarantees, as argued for in this book, or we will be facing times of uncertainty and upheaval. This was implicitly recognised by the ECB president when he urged acceleration of European Banking Union to 2015.

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