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Edited by
Fernando Fernández Méndez de Andés
IE Business School

In collaboración with Carlos Poza Lara
Universidad Antonio de Nebrija

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WORKING TEAM

DIRECTOR

Fernando Fernández Méndez Andés
Doctor of Economic Sciences and Professor of Economics and Financial Stability at IE Business School. International consultant. Board member of Bankia and Red Eléctrica. He has served as head of research at Banco Santander and chief economist at the IMF.

AUTHORS

María Abascal
Chief Economist for Regulation and Public Policies at BBVA Research. Trade specialist and economist attached to the Spanish Government (on leave). She has been Deputy Director General for Strategic and Financial Analysis of the Spanish Ministry of Economy and Finance and Cabinet member of the Spanish Institute for Foreign Trade (ICEX).

José Manuel Amor
Graduate in Economic and Business Sciences from Alcalá de Henares University. Master's degree in Banking and Finance from Analistas Financieros Internacionales (Afi). Head of Market Analysis at Afi and professor of the Afi's Master's Degree in Banking and Finance.

Ignacio de la Torre
Partner at Arcano. Academic director of the master's degrees in finance at IE Business School. Associate professor at IE Business School. Doctor of History from the Spanish National University of Distance Education (UNED). MBA from INSEAD Business School. Degree in Business Sciences from ICADE Business School. Degree in Law from the UNED.

José Ramón Díez Guijarro
Degree in Economic and Business Sciences from Complutense University, Madrid, and Master's Degree in Finance from the ICADE Business School. He is currently Head of Research at Bankia, Professor of Economic Environment and Country Analysis at the IE Business School and Professor of SpanishEconomic Structure at CUNEF.

Víctor Echevarría
Senior analyst at Analistas Financieros Internacionales (Afi). Víctor previously worked at the Economic Office attached to the Presidency of the Spanish Government, and was Senior Economist at BNP Paribas and Senior Country Risk Analyst at BBVA. Degree in Economics from Carlos III University. Master's Degree in Economics from Complutense University, Madrid.

Román Escolano
Vice President of the European Investment Bank. He was formerly President of the Official Credit Institute of Spain (ICO), Head of Institutional Relations at BBVA and Director of Economics at the Office of Economics attached to the Presidency of the Spanish Government. Degree in Economics from Madrid Autonomous University and Advanced Management Program from IESE Business School.

Santiago Fernández de Lis
Chief Economist of Financial Systems and Regulation at BBVA Research. Formerly partner and director of the International Department at AFI and Head of the International Department at Banco de España. He previously worked at the Bank for International Settlements in Basel and at the Secretariat of the Committee on the Global Financial System (CGFS).

Alicia García-Herrero
Researcher at Real Instituto Elcano and Bruegel and associate professor at the Hong Kong University of Science and Technology. Chief economist for Asia Pacific at NATIXIS. She was formerly Chief Economist of Emerging Markets at BBVA and Head of International Economics at Banco de España.

Rosa Gómez
Principal Economist of Financial Systems and Regulation at BBVA Research, with prior experience in the risks and accounting divisions. She previously worked at the Research Unit of Banco de España and at the Research Department of BHE.

Pablo Hernández de Cos
Doctor of Economics Sciences (Complutense University, Madrid) and degree in Law. Director General of Economics and Statistics and member of the Executive Committee of Banco de España. Alternate to the Governor on the Governing Council of the European Central Bank. Member of the High Council for Statistics and of the Board of Trustees of Centre for Monetary and Financial Studies (CEMFI), FEDEA.

David Martínez Turégano
Degree in Economics from Castilla-La Mancha University and Master's Degree in Economics and Finance from the Spanish Centre for Monetary and Financial Studies (CEMFI). Staff Economist, Monetary Policy and Euro Area Division of Banco de España. David previously worked at the research departments of BBVA, Catalunya Caixa and Analistas Financieros Internacionales (Afi).

Blanca Navarro Pérez
Head of Research at Instituto de Crédito Oficial (ICO). Blanca previously worked at the OECD and was associate professor at Carlos III University and the ICADE Business School. Master's Degree in Finance from Centro de Estudios Financieros. Degree in Economics from Zaragoza University.

José Carlos Pardo
Graduate in Industrial Engineering and MA in Financial Information and Systems from Deusto University. He is currently Head of Global Economics, Regulation and Public Affairs at BBVA. He was previously executive director of regulatory strategy at the Financial Department. Prior to BBVA, he was director at KPMG.

Javier J. Pérez
Head of the Fiscal Policy Unit at the Research Department of Banco de España. Javier previously served as Principal Economist at the Fiscal Policies Division of the European Central Bank, and is professor at Pablo de Olavide University in Seville and Complutense University, Madrid. Doctor of Economics(Complutense University, Madrid).

Carlos Poza Lara
Doctor of Economic Sciences from Complutense University, Madrid. Full professor of Economic Analysis at Nebrija University. Associate professor at the ICEX/CECO/Menéndez Pelayo International University. Associate professor at Carlos III University.

Phillip Souta
Head of UK Public Policy at Clifford Chance and lawyer in London. He was formerly a director at Business for New Europe and a lawyer at Carmelite Chambers London. Bachelor's Degree in Philosophy at the London School of Economics and Political Science (LSE).

Ángel Ubide
Doctor of Economics, European University Institute. Expert in monetary affairs, financial markets and European policies. Senior Fellow at the Peterson Institute for International Economics and member of the-executive committee of the Euro50 Group and the scientific committee of Progressive Economy.

Francisco Uría
State attorney on leave of absence. Partner responsible for financial services at KPMG. He previously served as Secretary General at the Spanish Ministries of Development and Finance. Francisco was also ViceSecretary General of the Spanish Banking Association (AEB), chairing its Legal and Fiscal Committees and representing it at the European Banking Federation.

ADVISORY GROUP

Mónica de Linos Escofet
Head of the ICO Foundation

Blanca Navarro
Head of Research at Instituto de Crédito Oficial (ICO)

Carlos Gómez
Research Unit at Instituto de Crédito Oficial (ICO)

Miguel Fernández
Research Unit at Instituto de Crédito Oficial (ICO)

Silvia Consuegra Rodríguez
Specialist at the ICO Foundation

Juan Carlos Ureta Domingo
President of FEFIEAF

Javier Méndez Llera
General Director – Secretary General of FEFIEAF

Alfredo Jiménez Fernández
Director of Analysis and Research at FEF

PRESENTATION

The ICO Foundation and Financial Research Foundation reached the joint decision back in 2012 to publish a periodic study called the «*Euro Yearbook*» with the aim of raising awareness and knowledge of the hugely important role played by the single currency while brainstorming new proposals and ideas so as to that ensure the euro gains further acceptance.

The ultimate aim of this partnership is to generate an annual publication explaining the major changes to have occurred during the year in terms of the monetary, fiscal, economic and political union, with further explanations as to what went right or where we might have fallen short.

To accomplish this, the report (now in its third year) is arranged into twelve chapters, each discussing the core aspects of the construction of Europe. The first three chapters outline the current state of the monetary union and gauge the extent to which the euro is used in international trade and within the financial markets. They also analyse the advances made towards financial integration in Europe and how monetary policy for the euro has panned out.

The following five chapters tackle specific subjects this year round and address the advances and developments see nin 2015. We therefore conduct an initial assessment of bank supervision by the ECB. The banking resolution framework is also analysed as a final yet incomplete step towards European integration. The chapters discuss the new task facing the European authorities in rolling out the capital markets union and analyse the challenges posed by the fiscal, economic and social union across Europe, with special attention paid to the infrastructure programme.

The remaining chapters address some of the questions left standing, such as: the role of European institutions in managing national economic and financial crises; the merits and impact of a mechanism for restructuring sovereign debt in Europe; the appeal of the European monetary union as a political reference for emerging countries; and lastly a look at the legal and economic consequences of a hypothetical Brexit.

The book features an executive summary that sets out the different contributions made by the collaborators and offers ten conclusions summing up the main points we wish to get across.

Once again, and in view of just how complicated and technical the situation is, one of our priorities in this book is to provide a detailed explanation of the many changes that have occurred within the monetary union, while analysing what they entail and the likely impact they will have for all of us.

The study was headed by Fernando Fernández Méndez de Andés, Professor at the IE Business School. He was ably supported by a team of renowned collaborators and contributors from the academic and professional realms, all of whom we would like to thank and congratulate for their excellent and invaluable contributions.

Financial Research Foundation and the ICO Foundation trust that the 2015 Yearbook will make a significant contribution to the current debate surrounding the euro and the construction of Europe and we also hope it will prove interesting to all readers.

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EXECUTIVE SUMMARY

Fernando Fernández[1]

1. INTRODUCTION

Five years have already passed since Fundación de Estudios Financieros first entrusted me with the task of describing and analysing the progress made towards the European Monetary Union, the last three years with the close support of the ICO Foundation[2]. The fact is that progress to date has left a bittersweet taste. While major advances have certainly been made (strengthening the European Central Bank's role as a federal institution; achieving a return to growth, albeit muted; rolling out a model of European banking supervision; and, above all, successfully navigating the Greek crisis), we have also seen unmitigated failures, such as persistent concerns over the mutualisation of bank debt being in the hands of the resolution mechanism and the proposed deposit guarantee scheme, plus endless debates on the merits of a fiscal union. Failures which European diplomats dress up as either delays or deferrals, but which illustrate that Europe as a whole is still very much split down the middle, with the two visions of the monetary union we described in last year's report struggling to coexist.

This subsistence becomes all the more worrisome when we consider that the monetary union is no longer news, no longer a priority, and has since been overtaken in both interest and urgency by the refugee crisis and the fight against Islamic extremists. Yet the euro is no longer a priority when there are still major political battles to be won to ensure that it remains with us and makes an ongoing contribution to the economic and social wellbeing of all Europeans. And nobody seems willing to spend their limited political clout on an arcane subject that is apparently no longer a concern. Once again we run the risk of falling into complacency: a risk that many were quick to denounce in the early years of the monetary union. At that time, the initial success meant cracks in the design of the institution went unrepaired, despite being well known to all authors, academics and politicians. Even today, all the technical problems have been perfectly flagged and diagnosed, yet we have lost that sense of urgency that now drives national political resistance. Once again, and as has so often been the case since the construction of a united Europe first began, if economic and social disaster has been avoided, why keep struggling towards a monetary union that the citizens of Europe do not feel at home with when there are more pressing issues to be addressed?

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[1] Fernando Fernández Méndez de Andés is a professor at the IE Business School and Director of the Euro Yearbook.

[2] Previous years' editions can be found on the website of Fundación de Estudios Financieros (www.fef.es) and on the website of Fundación ICO (www.fundacionico.es).

This is the main conclusion reached in the 2015 Yearbook, and one I would like to make clear from the outset. We are about to lose a great opportunity to finally consolidate a monetary, financial, fiscal, economic and social union across Europe (the selfimposed exile of the United Kingdom appears to be a foregone conclusion). It does not seem today like a major loss, because we are under the false impression that by adopting a concerted, heterodox and almost brazen attitude, the ECB will be able to kickstart growth and inflation, create employment and finally break free of the financial crisis. More's the pity. Over the coming pages I will attempt to show that this is a mistake; that the problems facing Europe are structural and cannot be overcome by monetary policy alone, no matter how creative we may make it. It is a belief shared by the authors of the various chapters, albeit with subtle differences and with different solutions to the problem, as any thoughtful reader will be able to discern.

Indeed this pluralistic view has always been one of the hallmarks of the Yearbook, which deliberately seeks to avoid unanimous opinion. This is because we are addressing a complex issue and an unprecedented experiment. Pursuing a voluntary and democratic monetary union that brings together a host of sovereign countries with different histories, institutions, traditions and economic and social structures, is inevitably going to be tough. But it is the challenge we Europeans have set ourselves to ensure our stability and prosperity in the age of globalisation while continuing to play our part in forging a richer, freer and fairer world. And this challenge cannot be overcome with simplistic, shortsighted or narrowminded visions. We must be critical, openminded and prepared to question common beliefs and purportedly safe assumptions. The same holds true in the economic realm. This is the challenge we have set ourselves in this year's edition, with each of us sticking strictly to our respective areas of expertise.

The situation in Europe in late 2015 allows no room for complacency, but nor for that matter despair or gloom. A good deal of progress has been made and the results are there to see. The economic recovery is a reality and the euro area is once again growing and creating employment. Economic activity across the euro area has been growing at a moderate pace (1.6% in 2015, 1.9% in 2016), but still beating general market consensus at the start of the year on the back of falling oil and commodity prices, an effective euro exchange rate with 6% depreciation, and remarkably expansive financing conditions thanks to the proactive role being taken by the ECB. European exports are witnessing healthy growth and the upturn in disposable income is pushing up domestic demand and making it the main growth driver within the context of a global slowdown affecting the main emerging economies. Financial fragmentation has eased, the differences in the cost of borrowing among the different countries of Europe have narrowed considerably and much more lending is now being extended to companies and households alike, although clearly short of the levels seen before the crisis[3]. Fiscal consolidation remains on track in Europe, albeit at a slower pace, while the global public deficit has dropped to an

[3] European Economic Forecast, Autumn 2015, published in November 2015.

[4] European Commission, 2016 Draft Budgetary Plans: Overall Assessment, COM (2015) 800 final, Brussels, November 2015. For an analysis of the limitations of this procedure, see Darvas and Leandro (2015).

estimated 1.9% of GDP this year and will continue to fall to 1.7% looking ahead to 2016[4]. Yet the public perception of this recovery has been far from positive and a certain sense of failure is becoming popular in Europe. Driving this sentiment have been the substantial country differences in terms of growth and income, balance of payments and particularly employment figures. Although these differences are no greater than those to be found in other major consolidated monetary regions, such as the United States, China and Brazil, their political significance cannot be compared. This not only because Europe is a political union under construction that needs to be endorsed by European citizens based on the results it achieves, but also because a number of Europhiles has thrust on us a simplistic and exaggerated version of the effects a monetary union can have on real convergence; one too akin to the boundless wealth and benefits an American country might expect to gain from pegging its currency to the dollar. Also contributing to the European sense of gloom is what I consider to be excessive concerns over deflation and the overly simplistic comparisons being made with Japan when neither the economic, technological, demographic or social circumstances are comparable.

As always, this Yearbook pursues a double objective: explaining what is happening and attempting to influence what steps to take next. Painting a picture of the European monetary union is not as simple as it might sound. The Union is in fact hugely complex, precisely because of the heterogeneity of the euro area and its multiple political, economic, social and strategic interconnections. Also playing a part is the increasingly bureaucratic system of decisionmaking and the tendency to hide behind technicality to conceal from the public eye the scale of the changes involved in building a united Europe It is rather depressing to see just how desperate politicians are to avoid the most pressing problems facing Europe. This is true of every single electoral process held in any country you might name; not only in European elections. How many citizens know that the monetary union involves a process of relinquishing more and more sovereignty to the institutions of Europe? How many are even familiar with these institutions if, in a bid to fit in, they hide their own identity and use a generic term to avoid social rejection? Previous Yearbooks insisted on the need to raise social awareness and the absolute and overriding demand for leadership. We have no other option than to once again repeat this plea, and we are convinced that publications such as this are the best antidote to the worsening case of Euroscepticism.

Yet an explanation is never enough. This book seeks to exert influence from Spain and help ensure, where possible, that the monetary union is ultimately successful for everyone involved. That also includes the Spanish. Because ensuring the longterm survival and stability of the euro area – an essential and unavoidable objective – does not necessarily mean that national interests are protected and guaranteed and that intelligent politics are no longer required[5]. On the contrary, balancing the success of the Union with the task of promoting Spanish interests is even more complex and requires considerable sophistication and maturity. For this reason, it is hugely important that we

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[5] See the author's article titled «Los Retos Estratégicos del Euro» in Geopolítica y Economía, Instituto de Estudios Superiores de la Defensa, Madrid 2015.

take part in reforging the monetary union from Spain by helping to shape this new Europe, because countries will continue to compete within the union – albeit with more standardised and less discretionary instruments – so as to develop and attract capital and talent with which to ensure the prosperity of their citizens. We are too quick to forget that the only way of ensuring success in European negotiations and of advancing our agendas within this conglomerate of contrasting interests that is Europe, is to have a legitimate State policy and to be consistent, systematic and even bold in applying it. It is essential to ensure exante national consensus on the shared understanding that Europe is, and will remain for the foreseeable future, a union of states and that there are Spanish national interests that transcend party politics and ideological differences.

For this dual task of explaining and influencing, I am proud to have had once again such illustrious collaborators at my side, all offering different ideologies, fields of expertise and often living far apart. The team, as always, has been crossdisciplinary, from academic to political analysts, and from financial and legal experts to consultants and regulatory specialists, and hailing from across Europe, America or Asia, because this time round we wanted to find out how outsiders look upon us Europeans. The European crisis is also a product of globalisation; not just an internal design flaw but above all the product of a shortsighted vision, one to some degree still associated with a closed and selfsufficient economy. Us Europeans are too inwardlooking and too proud and haughty of our growing irrelevance.

This book is a joint effort in which each author has set out his or her analysis and opinions with absolute freedom of expression. Some of these ideas may appear to be conflicting, while some are actually at loggerheads with my own, as I will explain in due course in this biased and deliberately selfserving summary. But what matters is that we all have the same objective in sight: –ensuring that the monetary union is successful and that us Spanish learn to compete and prosper within it– and also share the same attitude. We all believe that the only way of building a common, robust and lasting stance on the matter is through rigorous and brutally honest debate and with the utmost respect for the rules we all set ourselves. This is ultimately intended to benefit the reader, who can therefore draw his or her own conclusions. Because in Europe there are as many opinions as there are parties involved in the debate. Yet there are still some essential rules and principles we would do well not to forget, as I hope to make clear to those who have the patience to read this book.

A good deal has taken place in Europe in 2015, with the Greek crisis undoubtedly coming first on everyone's mind. A democratically elected government went head-to-head with the institutions of Europe by disputing the macroeconomic adjustment designed within the framework of the new rules of fiscal governance. After many ups and downs and a good deal of lost economic activity and recovery time, the episode ended with the ratification of the core elements of European fiscal discipline. With the benefit of hindsight and also of distance in our particular case, we can safely say it has been a positive experience for the Union. Because it has made it clear that the Union has a set of mandatory and binding rules in place that have been adopted by common agreement using the procedures in place. And also because it has shown that if a government attempts to rely on sovereignty to systematically breach these rules

time and time again, the offending nation will quickly find itself out of the Union as its funding runs dry. Greece attempted a risky move, a game of chicken if you like, and ended up having to change its policy stance, economic policies and ultimately its government; fortunately for everyone involved, particularly the Greeks themselves. But the Greek crisis has also taught us some important lessons, such as the need to improve fiscal discipline and complete its exante mechanisms while enhancing the region's macroeconomic stabilisation capacity, and also the need to ensure that creditors are made to pay the bill instead of enjoying their customary protection in restructuring processes. And there has also been some welcome news; thanks to major improvements made to Europe since 2010, virtually no financial contagion has spread to other peripheral countries. The markets have managed to discriminate between breaching and nonbreaching countries and between those nations whose governments are committed to the monetary union and their ensuing obligations and those that are not.

Yet there have been many more significant developments during the year: (i) the rollout of a massive quantitative easing programme by the ECB, involving copious buying of public bonds from all Member States. The initiative has led to rockbottom interest rates, with some even dipping below zero for government borrowing of up to two years; (ii) the first full year of European banking supervision via the new Single Supervisory Mechanism, which has superseded traditional supervision by the Bank of Spain – one very much based on accounting norms and compliance with ratios – in favour of a system of discretionary, albeit standardised assessment of policies, rules and governance of risk management; (iii) renewed concerns over the true scope, and particularly the timing of the banking mutualisation process with the need to approve the regulation of the resolution mechanism and with the proposed deposit guarantee scheme for Europe; and (iv) the approval of the socalled Juncker Plan, a panEuropean fiscal expansion project to be accomplished by boosting transnational public investment. The plan comes in response to certain criticisms concerning the absence of automatic stabilisation mechanisms within the euro area, but is a far cry from the real fiscal union in relation to which there is so much hype.

And on the subject of political governance of the euro – a key concern at this level – the main development of 2015 has undoubtedly been the Five Presidents' Report[6] and the subsequent Action Plan of the European Commission and roadmap for a political union, as the Commission seeks to reassert its leadership after seeing the European Parliament gain further legitimacy in the wake of the elections. And let us not forget the bombshell of British opposition to the proposed monetary union and the country's planned referendum to rewrite the rules governing its adhesion to the European Union.

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[6] The Five Presidents' Report is properly called *Completing Europe's Economic and Monetary Union,* and is in reality a report by JeanClaude Juncker, President of the European Commission, in close cooperation with Donald Tusk, President of the European Council, Jeroen Dijsselbloem, Eurogroup President, Mario Draghi, President of the European Central Bank, and Martin Schulz, President of the European Parliament. It contains five chapters offering a roadmap of the process: the nature of the EMU, the Economic Union, the Financial Union (banking and capital markets), the Fiscal Union, and accountability, legitimacy and institutional strengthening of the EMU.

Certainly a major challenge for the year ahead. We discuss all this at length in this Yearbook. I will attempt to provide an outline of these discussions in this Executive Summary.

2. FROM THE CURRENT STATE OF THE MONETARY UNION TO ITS FINISHED STATE AND ALL QUESTIONS IN BETWEEN

The Yearbook starts out by discussing the functioning of a normal monetary union before moving on to analyse the regulatory and legislative developments seen during the year. It ends with a discussion of certain still theoretical yet nonetheless pressing issues that the Union will undoubtedly have to address in the short term. As part of the first step, and as is only customary, we will address the use of the euro within the different markets, while discussing changes and the measures rolled out to combat financial fragmentation and providing a description and analysis of the ECB's monetary policies. New features this year round include an evaluation of the ECB's supervisory activity, a description and analysis of the incomplete European banking resolution framework, a preliminary study of the impact of the proposed capital markets union and lastly a 360º look at the transformation of the Stability Pact into a bonafide fiscal union, with particular attention paid to the infrastructure programme for Europe. The Yearbook also includes a third block of chapters that offers diverging and certainly controversial viewpoints in relation to some of the challenges left standing: the role of European institutions in managing national economic and financial crises; the merits and impact of a mechanism for restructuring sovereign debt in Europe; the appeal of the European monetary union as a political reference for emerging countries; and lastly a look at the legal and economic consequences of a hypothetical Brexit.

The Yearbook starts by describing the main trends and changes in the use of the euro as a means of payment in the international trade of goods and services both within and outside the euro area and also as an international reserve currency. It also explains the extent to which the European currency is used across the different financial markets. As confirmed by the author, Carlos Poza from the University of Nebrija, nothing much has changed in that the euro continues to play a prominent role as a regional currency, but has a long way to go if it hopes to challenge the dollar as the main international currency. In fact, this should come as little surprise to anyone given how new the currency is in relative terms, coupled with its institutional limitations and the lingering uncertainty as to the degree of real integration and sustainability of the euro area; concerns that nevertheless did nothing to prevent yet another new member, Lithuania, from joining the euro area in early 2015.

The euro's role in the world of international trade remains stable in terms of both exports and imports shares of goods and services. Yet this relative global stability hides major differences between the different Member States, illustrating their uneven share of trade and their different commercial patterns. A prime example here is the euro's relatively scant presence in Greek trade following the steppingup of trade relations with Russia within the context of its political vacillations, or the high share of Eastern European countries, which is the counterpoint to its growing commercial integration with Germany.

Use of the euro as an international reserve currency continued to retreat in 2015 at constant prices, suggesting that the Chinese renmimbi is gaining weight at the expense of both the dollar and the euro, which has nonetheless retained its coveted second place ahead of the yen, the pound sterling and others. It will be interesting to see in the coming years how exactly these percentages change in light of the growing internationalisation of the Chinese currency and its inclusion within the Special Drawing Rights (SDR) – the basket of reserve currencies used by the IMF in its programmes and therefore by the world's main central banks. The euro's importance as an international currency is also apparent from the number of countries that include it in the currency basket to which they peg their exchange policy. Two of these, namely Bosnia and Herzegovina and Bulgaria, follow a formal conversion system with the euro, while a further 34 include the euro in one way or another as an explicit reference on which to fix the exchange rate for their national currency. The latest country to do so was China following the changes in its exchange policy.

Use of the euro in the different financial markets is slowly but surely declining at constant exchange rates. This is the result of lingering tail risks concerning the sustainability of the single currency, the ECB's penalisation of excess liquidity held in euros, and growing banking penetration and development of debt markets in local currency across the main emerging economies. Accordingly, we have seen a drop in both the percentage of worldwide euro deposits and borrowing and in the volume of debt denominated in euros. That said, the growing divergence in monetary policy between the United States and Europe has led to a greater use of the euro in the exchange markets and in interest rate derivatives.

In chapter 2, José Ramón Díez, head of research at Bankia, provides a fresh analysis of the existing fragmentation across the different segments of the eurozone financial market. His findings reveal a significant reduction across practically all fragmentation indicators, which are again approaching the levels seen prior to the crisis: price dispersion has dropped, volumes have grown and domestic bias has fallen in certain markets, including the money market. And what I believe is even more significant is the fact that the fragmentation indicators barely noticed any pressure at the height of the Greek crisis, showing that the firewall resulting from a combination of the banking union and the concerted action of the ECB has functioned reasonably well under stress conditions.

In the money markets: (i) we have witnessed a continuation of the steady reduction first seen in 2012 in the levels of dispersion between interest rates traded on the different markets, which is now close to zero; (ii) the geographic range of counterparties has continued to widen, especially in countries that experienced a crisis, with a resulting drop in home country bias and investor aversion to certain countries; (iii) yet there remains considerable excess liquidity. Excess liquidity that is no longer so much a product of depositary institutions seeking security but more a case of ECB policies – the TLTRO and the asset purchase programme we will discuss further on this Yearbook – which have led to a necessary reduction in the volumes traded on the money markets as the ECB now plays the central role of market maker, replacing direct exchanges between entities.

The sovereign bond market is the most well known of these and is the real focus of public attention. The shrinking spread between Spanish debt and the German bund has

become almost a matter of daily discussion and political debate. Without doubt the positive change here is a product of three inseparably conjoined factors: the actions of European governments, which have taken place at varying paces and intensities, to ensure greater discipline and sustainability in relation to public accounts; the monetary policy decisions reached by the ECB; and the progress made in relation to the institutional architecture of the euro area and, more specifically, the advances made towards mutualising bank and sovereign debt. The narrowing of spreads has also sparked a recovery in the percentage of short and longterm government bonds in the hands of foreign investors and also in the presence of foreign instruments in the portfolios of domestic financial institutions. That said, current levels are still a far cry from the situation before the crisis broke. Corporate bond markets have also rallied and are showing less fragmentation, although issue volumes have continued to drop as a result of the necessary deleveraging process.

The drop in financial fragmentation has been particularly intense in certain retail markets that are especially important for peripheral countries such as Spain. The spread on the cost of borrowing between Spanish SMEs and their German counterparts shed 200 basis points to dip below 60 in September 2015. Apart from the drive to detoxify and recapitalise the banking sector, this spread reduction has unquestionably been pivotal in putting Spain back on the path to growth and employment, meaning borrowing is no longer the main worry of Spanish companies. If this was the overriding objective being pursued by the ECB on its crusade of quantitative easing, then it was certainly successful in its task. That said, the collateral costs associated with this success are another issue, as we will discuss in due course.

Yet the purpose of this chapter is not just to describe how positively the markets have performed, but also to address the limits affecting the trends we have observed. It will be difficult for this ongoing normalisation and integration to continue without farreaching structural reforms, illustrating the need to press on with the capital markets union to remove the legal and regulatory barriers that are still blocking crossborder investments in the European Union and also to aid in the development of further financing systems and channels for corporations and firms to complement existing bank lending. Fortunately it seems the Commission has made this objective a political commitment, as we will see later.

Lastly, this chapter draws a distinction between liquidity in circulation on the one hand and market liquidity on the other to reveal a growing concern among financial operators: the fact that excess liquidity exists alongside the temporary difficulties faced by investors when they attempt to sell up without incurring dramatic losses, and with sporadic shocks affecting certain markets, with heavy price fluctuations due to the reduced number of transactions. Multiple factors have been behind these episodes: stricter regulatory capital requirements for carrying out certain activities, the development of electronic trading platforms, the fact that investment banks are being replaced by investment funds as the main market makers and generators of liquidity (as the latter require more liquidity), and even the mass buying of assets by central banks. Our complete and thorough diagnosis of the problem leads on naturally to a discussion of the policies needed to prevent this risk from materialising.

Chapter 3 contains an analysis of monetary policy for the euro area. In the chapter, Blanca Navarro, of the ICO's Research Unit, provides an exhaustive description of what

she rightly calls «the year of the ECB's change of focus from a banking perspective to direct intervention». This change includes measures to guarantee financial institutions infinite liquidity at zero cost, coupled with the ECB's intervention by directly purchasing financial assets to feed this liquidity through to governments, companies and individuals in a bid to replace the bank transfer mechanism, which was not working properly. A strategy previously adopted by the world's main central banks, but which the ECB has not followed to the letter when taking up private credit risk, due to the institutional restrictions placed on it.

The chapter begins with a description of the monetary policy decisions of the main countries within the context of their respective economic performance, stage of the economic cycle and fiscal situation. It describes the difficulties the US Federal Reserve is facing in setting up a credible strategy for breaking free of the brutal expansion of its balance sheet in recent years and in communicating this policy to the market, while the ECB is adamant on stepping up support for what it still views as a fragile process of recovery. This divergence in the stance of monetary policy has been behind the fluctuations we have seen in the eurodollar exchange rate and is going to be one of the great unknowns the asset markets will have to face in 2016. The question on the lips of every analyst is whether the ECB has implicitly adopted an exchange rate objective and whether in doing so it is encouraging a currency war the IMF has been denouncing yet at the same time fanning by urging the Fed to wait even longer before hiking interest rates.

The main thread of the chapter offers an indepth description of all the monetary policy decisions adopted by the ECB in 2015. The chapter answers any lingering doubts as to what exactly a programme involves, when and why one might be rolled out, what are its main technical characteristics, who carries out the transactions and how, how much is purchased in each programme of each security, and so on. Suffice to say for the time being that the ECB has injected upwards of one trillion euros through the three instruments included in the asset purchasing programme launched in March 2015: sovereign bonds account for 80% of the roughly 60 billion euros a month, with covered bonds contributing 18% and securitisation bonds just 2%. Also of interest here is the analysis of emergency liquidity assistance (ELA), a measure designed to help specific institutions in times of need and which with the Greek crisis has become the instrument of last resort for monetary discipline and economic policy. President Draghi has acknowledged that we need to reconsider the decisionmaking process (which affords the ECB immense political power) and disclosure rules (opacity can no longer be justified) of what in practice is and will be the final backstop against possible speculative attacks or the final trigger of a scenario involving the unilateral breakup and abandonment of the monetary union.

The ECB has been very careful in offering a theoretical justification for this new policy[7], probably because it is fully aware of the prevailing scepticism, if not downright

[7] BCE, «*The role of the Central Bank Balance Sheet in monetary policy*», Economic Bulletin, 4/2015, pp. 6177.

hostility, it is facing mainly from the academic community and European politicians, and not just in Germany. It has therefore been at pains to point out that policies affecting the ECB's balance sheet are the only effective defence against deflation when a zero interest rate policy is no longer effective. And this is certainly the case, because they operate through the different asset price channels, restructuring (substitution effects) the balance sheets of private investors and their expectations, by unambiguously setting up a scenario of very longterm rates and liquidity.

The complex institutional context in which the ECB operates and the need to delicately balance very different positions was illustrated by the public sector purchase programme (PSPP), in which the following had to be agreed upon beforehand: the distribution of buying by country, which is based on their participation in the ECB's capital; acceptance of the pari passu clause and forfeiture of their status as preferred creditor so as not to crowd out private investors; the limit on the total percentage of any specific issue that can be held by the ECB to prevent the application of collective action clauses; and the framework for sharing and potentially mutualising risks – extremely limited in practice as the risk is assumed by the purchasing entity, which are the National Central Banks, while the ECB assumes only 8% of the total, except when purchasing instruments from supranational entities.

The chapter focuses on the ECB's approach and its three channels of action to offer a quantitative assessment of the effects of the new monetary policy. The effect on the price channel is clear, as we have already indicated. The substitution effect is a little less obvious to see, as the search for profitability by investors has raised the average risk profile of their portfolios and created potential bubbles in some financial assets and real bubbles in other markets. Debt, stock markets and real estate in some emerging economies are the obvious candidates. As regards the effectiveness of the third channel, it is very difficult to have anything more than an intuitive inkling as any attempt to gauge how inflation expectations might have changed without quantitative easing would be an exercise in futility. The effects of QE on the recovery of credit volumes in the private sector and on the depreciation of the euro are certainly clearer to see.

Yet it is important also to highlight the risks associated with these heterodox policies; risks concerning the effectiveness of market intervention in European economies dominated by bank financing and in which these measures, despite improving bank solvency, drag down their profitability and therefore their capacity and appetite to assume risk. Risks that are even more pronounced for the insurance sector. Risks of bubbles forming, as mentioned previously, which can undermine international financial stability if they appear in major markets such as China or Brazil. And risks concerning how best to distribute the adjustment cost and the capacity for future growth. A policy of quantitative easing, regardless of format, is a sophisticated means of financial repression by keeping returns on savings artificially low. It effectively entails a transfer of income from agents, companies and households who save to those who rely on debt. A transfer which, as in the story of the ant and the grasshopper, raises not only ethical dilemmas but also functional ones: a dilemma concerning its effectiveness over time. How to recover rates of investment, growth and employment without savings? Particularly when we look at economies in which the debt of public sector and private agents is already at an alltime high.

Yet there may be other less conventional and more critical interpretations of the ECB's actions, which we can sum up in the following points[8]. Firstly, the currently rock-bottom interest rates cannot be the new equilibrium. The secular stagnation[9] hypothesis, imported from the United States and providing a more sophisticated theoretical justification for the new monetary stance, is built on questionable hypotheses: the irreversible ageing of the population, the excess of global savings and an allbut depleted technological revolution that has also failed to spark any sustained growth in productivity. Secondly, periods of financial expansion necessarily leave their mark on the real economy. Specifically, financial booms tend to be bad for productivity growth as they push workers and other production factors towards sectors that are growing more slowly. The extent to which abnormally low interest rates can help correct what is essentially a structural problem affecting the job market remains unclear. Thirdly, the longer the currently very low interest rates persist over time, the more lasting damage this could cause to the financial sector. Fourthly, there are numerous shortcomings within the international financial system, which has failed to become suitably adept at preventing the buildup or transfer of financial imbalances between countries and monetary jurisdictions. We must weigh up the merits of developing new international rules to help enhance discipline in national politics. And fifthly, and strictly in relation to Europe, it is unclear whether expansive monetary policies are capable of offsetting the delays and vacillations we have all seen in building an optimum monetary area. All things considered, although it is undeniable that the recent crisis is forcing us to rethink certain core macroeconomic assumptions and pushing prevailing academic opinion towards the idea of greater monetary and fiscal activism and a more prudent approach, what we might also be seeing is a pendular movement rather than a rush for the finish line. We have no historical precedent or benchmark with which to figure out the real and lasting consequences of what is an extraordinary monetary policy that is raising concerns regarding its actual utility and collateral effects; concerns that are growing in all directions the longer it lasts.

Since November 2014, the ECB is not only responsible for monetary policy alone, but has acquired microprudential supervisory powers across the euro area as we take the final steps towards banking union. Francisco Uría, head partner responsible for financial services at KPMG, analyses the rollout of the Single Supervisory Mechanism (SSM) in chapter 4. Over the course of 2015, Spanish banks have been steadily adapting to the system of direct communication and collaboration with ECB supervisors, while the ECB has had to get used to working with a whole host of financial institutions with different balance sheets, systems of governance and regulatory backgrounds. For its part, the Bank of Spain has had to come to terms with its new role of liaising closely with the ECB, while having less direct contact with the banks themselves. It has been a hugely complex, intense and difficult year, but certainly a satisfactory one in spite of everything. As we will

[8] Ideas discussed at greater length by Fernández (2015), «El BCE y los límites de la política monetaria», ICE, September 2015.

[9] Thesis originally formulated by Ben Bernanke and Larry Summers for the U.S. economy and which then crossed over to Europe (Teulings and Baldwin (eds.) 2014) as a theoretical improvement to the assumptions of European structural imbalance previously dubbed «Eurosclerosis».

conclude later on in this chapter, the experience has been globally positive for all parties concerned.

Make no mistake, the ECB has had an extraordinarily busy year. It has succeeded to set up its management and supervisory teams; it has rolled out a brand-new supervisory procedure known as SREP, which marks a break from many traditional national approaches; it has successfully completed its first global supervisory evaluation process; and it has been able to maintain complete independence between the two functions entrusted to it, namely monetary policy and supervisory authority. Yet the sheer speed with which things have happened has also entailed a massive workload for financial institutions, which have had to dedicate a huge amount of material and human resources towards supervisory targets. Mutual collaboration and the desire for ongoing dialogue have always been part and parcel of the process. But it is also true that there is a growing fear among banks that they are becoming overwhelmed by the speed of the regulatory and supervisory change. Strictly speaking this is not the supervisor's problem, but the more financial institutions are forced to comply with processes, systems, reports, indicators and changing evaluations, the more difficult it will be for them to plan accordingly and make the right decisions.

For Spanish banks, their biggest concern has been the new supervisory process known as SREP[10]. A process that is less transparent than it should be, as institutions can only learn about it indirectly through the guide to banking supervision published by the ECB in November 2014, without having access to the key document, the ECB Supervisory Manual. Spanish institutions were accustomed to supervision based on their compliance with Basel regulatory requirements on capital and liquidity; a supervision that focused on accounting rules, making the Bank of Spain pretty much an exception within Europe in that it maintained regulatory authority over the accounting of banks. In contrast, the ECB has branched out into new supervisory fields such as the analysis and evaluation of corporate governance, the quality and management of underlying information (not just risk measurement), and business models and recurrent profitability. In a model clearly inspired by the traditional CAMELS[11] of the Federal Reserve, the ECB has attached particular importance to the supervisory dialogue and the qualitative evaluation of management aspects. As the author of the chapter points out: «this places the supervisor in an uncertain position in which it must proceed with great caution», especially when we consider that these are core competencies of the governing bodies of financial institutions.

The supervisory year started out with the qualitative outcomes of the 2014 comprehensive assessment process, enabling the ECB to verify in situ an absence of regulatory harmonisation; a product of agreed-upon national discretions[12], and which significantly affects not only capital definitions, the treatment of holdings in insurance companies or

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[10] Supervisory Review and Evaluation *Process* under the SSM Regulation.

[11] *Capital, Assets, Management, Earnings and Liquidity*.

[12] The chapter identifies over 150 options and national discretions (ONDs) in the regulatory transposition of the Basel III framework. And the ECB is legally required to apply the European Directives and Regulations and also the national law that transposes these.

deferred tax assets, but also the quantity and quality of the information required of institutions and the mandatory differences in the degree of allowances and provisions for homogeneous loan books. The consequences will not be accounting related, as the ECB has no authority there, but will instead impact the capital requirements of institutions under Pillar 2 of Basel. It is here where the SSM has revealed its discretionary nature.

Doing away with these national exemptions has been, and will remain, a priority in the supervisory work of the ECB. Not only because of the need to ensure a level playing field for all banks, thus allowing them to be benchmarked while ensuring transparency for investors, but also because it is a necessary step in facilitating the integration of financial markets across the euro area, and lastly because the ECB believes that some of these differences are concealing national practices of regulatory protectionism. While this priority is certainly understandable, the supervisor must take great care and keep the dialogue flowing so as to ensure both fairness and efficiency during the transition process.

Lastly, a large part of the supervisory work was given over to the governance and business models of the institutions within the context of their risk appetite. To such ends, the supervisor examined the minutes of governing bodies, documented the flow and timing of information made available to boards of directors and their committees, and attended company meetings; an interesting move that is not without its controversy, because if the supervisor institutes action, including legal action, its presence on the board and its silence on the matter could be construed as being tantamount to tacit acquiescence of the decisions reached by the supervised banks.

The aggregate results of the first SREP were released in early December and so could not be included in Francisco Uría's contribution to the subject. Spanish banks successfully passed the evaluation, having improved in 2015 their capital adequacy, liquidity and profitability in aggregate terms. All of them received a letter with their individual results. Apart from spelling out the regulatory requirements, these letters also offered improvement recommendations for not only capital and liquidity but also governance and management. We only know the aggregate results for the banking system as a whole, since the ECB has reached a decision that sits uncomfortably with its insistence on transparency: it will not publish individual results, although it reckons there may be national situations warranting their publication. A number of market regulators have indeed forced financial entities to publish their results on the understanding that the information is of primordial importance to individual investors. It certainly seems reasonable to assume that the levels of capital and liquidity required by the regulator constitute relevant information, all the more so when we remember that these levels are discretionary as they include an additional judgement as to the quality of the company's management and governance, and as to the sustainability of its income statement and business model. And it would be a bad start for a European banking supervisor if its decisions were to be amended by national financial asset market supervisors.

I believe the supervisory path taken by the ECB is the right one to follow. Supervision is not mechanical and should not be limited to simply reporting on compliance with this or that ratio, not matter how sophisticated they may be. It must be forwardlooking and must therefore include value judgements and discretionbased aspects. But this is preci-

sely the reason why the supervisor must ensure transparency and public accountability for its decisions. Discretionality demands accountability.

To press forward with the banking union, the Single Supervisory Mechanism (SSM) must be followed immediately by a Single Resolution Mechanism (SRM). The current situation and its limitations are addressed in chapter 5 by María Abascal, Santiago Fernández de Lis and José Carlos Pardo, all of BBVA Research. Within the new regulatory landscape, banking resolution pursues two core objectives: ensuring that banks are allowed to go bankrupt much like any other company, without creating a systemic problem and without therefore having a major impact on the real economy, and ensuring that taxpayer money is not needed to bail them out. These objectives entail the need to set up an internal resolution fund for the financial sector, thus creating a kind of dedicated banking insurance to minimise, or even completely do away with the need for a public guarantee or fiscal backstop in the event of a widespread crisis of confidence. In a monetary union designed to last, such as the European one, we have a third objective: ensuring that banking crises do not evolve into sovereign crises and raise doubts as to whether the affected country should remain in the union, thus requiring a certain level of "mutualisation" of bank risk extending beyond national frontiers. It is hardly surprising then that the implementation of a European resolution system is proving to be highly contentious.

The centrepiece of the European resolution system is the concept called "bail-in", whereby the bank's shareholders and creditors are required to meet the losses. To ensure compliance with this principle, and following the enactment of the Bank Recovery and Regulation Directive and Regulation (BRRD and BRRR) discussed in last year's edition, the aim was essentially to (i) guarantee this loss-absorbing capacity by setting up regulatory ratios such as total lossabsorbing capacity (TLAC) for systemic institutions and the minimum requirement for own funds and eligible liabilities (MREL); (ii) create a European Resolution Authority to ensure equal treatment among European institutions and avoid regulatory forbearance and protectionism[13]; and (iii) define the necessary level of mutualisation by creating a European Resolution Fund. It is precisely this last point, and the corollary existence of a European public back-up system – to use the proper term – that has generated the most heated discussion, even after its approval, with the resulting set-up proving somewhat less satisfactory than desired in terms of the sustainability of the monetary union[14], as the authors rightly assert.

The Single Resolution Fund (SRF) will come into existence in January 2016, funded by the contributions made by participating banks until it reaches a size equivalent to 1% of all covered deposits in the euro area. The mutualisation of bank contributions will be phasedin over eight years, although the bulk will take place in the first two years, by the

[13] The fact the Authority is based in Brussels and not Frankfurt is no mere coincidence, but rather a clear indication that resolution always has a component comprising public funds that requires the involvement and control of the political authorities and a safeguard to guarantee that the Authority remains independent from the ECB to ensure a proper separation of supervisory and resolution functions. In the case of Europe, the concerns raised by certain countries over the excessive power vested in the ECB within the new institutional framework of the EMU have also undoubtedly played a part.

[14] For a critique of the work that still remains, see Schoenmaker (2015).

end of which the fund will have reached 60% of contributions. The SRF is a secondary resolution mechanism and will only be resorted to when the losses sustained by the bank's creditors account for at least 8% of liabilities. Should the SRF prove insufficient (the fund has a target level of 55 billion euros), additional mechanisms are envisaged, such as levying charges from the banks themselves or even placing debt instruments on the market. The agreement also envisions public backing as a last resort, but this point has yet to take proper shape as it has come up against heavy resistance, including legal action. There are those who believe it is incompatible with the Treaties and with certain national constitutions on the belief that it creates contingent obligations without prior parliamentary approval. Although the likelihood of this public support being needed is minimal given the size of the SRF, the existence of *black swans* is still one of the lessons that should be learnt from the current crisis. This lack of a *fiscal backstop* is the main sore point among analysts and investors with the SRM and even one of the weaknesses flagged in the Five Presidents' Report.

The chapter also explains the new resolution framework in Spain, since, in the typical scheme of European subsidiarity, the first pillar of the new common system is the harmonisation of national markets. Our country has adopted a two-pronged system, a product of the changing institutional balance between the Bank of Spain – which has been entrusted with preventive tasks and by that we mean reviewing the recovery plan that all institutions are required to draw up and devising the Resolution Plan[15] – and the FROB, the Spanish Resolution Authority, which is tasked with the operational resolution of those institutions that require resolution. This complex set-up will actually become considerably simpler in 2016 following the start-up of the European Resolution Authority, which will take over many of the preventive functions currently assigned to the Bank of Spain in relation to all systemic institutions, which currently account for 90% of the Spanish banking system.

The bail-in principle is also proving difficult to apply, especially in relation to the treatment of senior debt. In practice, the aim is to ensure, from a legal standpoint, that lossabsorbing debt is made structurally subordinate –, either contractually or by statute–, to all the institution's operating liabilities. And different European countries are tackling this in different ways, thus running the risk of confusing investors and introducing competitive differences among the institutions involved, depending on where they are based, when complying with new lossabsorbing requirements such as TLAC and MREL. These differences can be seen when we compare the model adopted in Spain, in which senior debt may or may not, depending on the issue, have priority over unsecured deposits, and the German model, where senior debt is made subordinate by statute and is invariably classified as Tier 3 capital.

European banks are currently awaiting a decision from the Resolution Authority on the final amount, composition and distribution of the minimum requirements for own

[15] An important point that has yet to be answered when preparing these plans in relation to internationally active banks is that the Resolution Authorities need to formally acknowledge the necessary reporting differences between banks that have resolution models with multiple entry points – whose international structure is based on autonomous and fully-capitalised subsidiaries – and those that have a single entry point and do business through the branch model.

funds and eligible liabilities in the event of resolution, or MREL for short. It is a strategic challenge that may well shape the future landscape of the European banking sector. To get it right, one must know the liabilities structure of each bank; understand the resolution strategy of each institution by clearly identifying in the recovery plans those business activities that are critical to financial stability; accurately define what instruments are eligible on the clear understanding that no asset can be treated worse during resolution than during liquidation; and, lastly, establish a phasein period to ensure that institutions are able to honour their obligations without seriously undermining their ability to provide credit to the economy.

The final architecture of the banking union requires a European deposit guarantee scheme; a move Germany and certain other countries are strongly against due to the fact that there is no existing fiscal union. But aside from the constitutional difficulties and the question of whether the Treaty would need to be reformed beforehand, the fact is the scheme remains a technical necessity, as analysts, academics and policy makers alike have been saying for years. The chapter therefore describes at some length what is needed in order for the scheme to work properly, as well as the challenges in implementing it and the various alternatives on the table.

After the chapter was completed, on 24 November the European Commission released a proposal containing its plan to gradually implement a common framework for guaranteeing bank deposits across Europe (EDIS[16]). The authors agreed to add a postscript setting out the main lines of the proposal. The Commission is envisaging a gradual rollout of the European scheme, which would start out as a system of reinsurance among national funds before gradually morphing into a type of coinsurance scheme and then finally evolving into a full European fund in 2024, thus giving sufficient time for those countries that do not already have one to implement a prefunded system. The Commission's proposal is a necessary step towards completing the banking union while mitigating the risks of euro area fragmentation stemming from the sovereignbank vicious circle. That said, this initiative would become more credible if a public backstop were to be set up across Europe. Even so, certain countries view this as unacceptable and are opposing any attempt for further mutualisation and federalisation as they continue to press for a model of European integration based solely on common rules and national responsibility. Their position would be much more understandable, both technically and politically, if they were able to come up with a specific and viable proposal for fiscal union to be implemented side by side with any further mutualisation. In the meantime, their words are coming across as a feeble excuse as their political clout begins to wear thin and as they risk undoing everything that has been achieved so far. Because the art of institutional design essentially involves preparing for the worst and not assuming that the storm has passed, no matter how benign the macroeconomic and financial conditions may seem today.

Having defined a path towards the banking union, albeit with some way to go, the next challenge in building a European Union from a financial standpoint is the capital

[16] *European Deposit Insurance Scheme.*

markets union (CMU). The Juncker Commission therefore set the CMU target in its Green Paper of February 2015 and announced an action plan in September. For this reason and also because of the clear advantages it would mean for Europe in terms of both growth and employment, the subject is tackled by Ignacio de la Torre, partner at Arcano, in chapter 6. The European priorities are clear: fostering the creation of efficient and liquid financial markets for SMEs, facilitating long-term investment and the development of the private placements market, relaunching the securitisation market, breaking down internal barriers to movement of capital, and encouraging investment in private equity funds to drive modernisation and technological change.

The financial differences with the United States are clear and wellknown. Europe is a bank-heavy economy, with the size of its banking system roughly three times GDP, whereas in the United States the banking system stands at virtually 100%. In contrast, capital debt markets barely account for a fifth of GDP in Europe, while in the US they are also roughly equivalent to its GDP. For the author these differences largely explain the relative speeds with which these two regions have broken free from the crisis and seen a return to growth.

The chapter offers an interesting synthesis of the advantages of a capital markets union: homogeneity and capacity to diversify risk, access to longer-term financing, easier market access for SMEs by extending the corporate bonds market, opening up the securitisations market and integrating and redesigning alternative stock markets. On top of these advantages the author offers a fascinating glimpse of a possible future: the capital markets union could help reconnect the United Kingdom with the European Union, a point we will return to in due course.

Yet highlighting the importance of developing a deep and liquid European capital market does not mean we are forgetting the difficulties in creating one. The challenges are indeed formidable. First, the existence of multiple jurisdictions has given rise to an extremely heterogeneous legal, regulatory and fiscal landscape, making it difficult to standardise financial products and market them on a European scale. Secondly, the persistence of different supervisors with different and sometimes even conflicting practices and approaches has resulted in fragmentation and prompted the search for regulatory arbitrage opportunities that have not always proven effective or safe for issuers and investors. Thirdly, the fact we have international accounting standards for large companies and other national standards for SMEs has made the task of analysing and comparing balance sheets and income statements for SMEs all the more difficult. Fourthly, the smaller the market the smaller its firm size, further exacerbating their difficulties in accessing capital markets. Fifthly, national differences in the operational architecture of the markets push up crossborder transaction costs and reduce liquidity. Moreover, and as the author rightly argues, developing a transparent and efficient capitals market will mean fostering and improving financial culture among the population.

The rest of the chapter contains a proposed action plan for bringing the European capital markets union to fruition. A proposal in which we must take into account both the providers of capital, namely investors, and those that require it, namely potential issuers. If we fail to satisfy both sides, meaning if the result is not attractive to both, the union is unlikely to prosper and will not be effective at improving savings and investment volu-

mes across Europe. The changes in market infrastructure that the new European regulation hopes to introduce must invariably pursue this dual objective and count on the participation of market makers. In chapter 7, Pablo Hernández de Cos and Javier Pérez of the Bank of Spain analyse the path leading from the reform of the Stability Pact towards fiscal union. The path has not been without its twists and turns, and indeed not even the roadmap was in place when the first steps were taken. There are also different opinions on where the path will eventually end. But what is true is that the Union has greatly reformed and strengthened fiscal coordination, governance and discipline since the concept was first set out in the Treaty on European Union and the Stability and Growth Pact (SGP). Whether this has followed the proper path and whether it has ventured too far or fallen short are questions we hope to shed some light on.

The economic crisis highlighted the frailties of the original institutional framework of the EMU: the mechanism for coordinating economic policies simply did not work and did not allow for the desired structural reforms to be implemented, while the Stability and Growth Pact was unable to stimulate sustained consolidation in public accounts. Moreover, the absence of crisis management mechanisms meant the first symptoms of the crisis went untreated and allowed the rot to spread. The acknowledgement of the original design flaws led to a review of the fiscal governance framework[17]. The successive rounds of legislative initiatives, which were not always well harmonised, (*SixPack,* Treaty on Stability, Coordination and Governance, the so-called *Fiscal Compact, Two-Pack,* and lastly the European Semester) created a completely new yet confusing and contradictory fiscal landscape that is largely unknown to the general public, and even to numerous experts, making it less legitimate in the eyes of many and weakening political support.

In tandem, the euro area has been striving to build a crisis management framework and one in which fiscal policy is a key feature. This has led to the creation of the European Stability Mechanism, or ESM for short, whose general function is to channel financial support to eurozone countries in need of such aid, but subject to strict conditions. Yet, as always, given the Union's invariably complex setup, the ESM does not set these conditions itself, which would have made it a bonafide European Monetary Fund. Instead, it is the joint responsibility of the so-called Troika, meaning the Commission, the ECB and the IMF, with the assistance of the ESM. A tangled knot of different institutions that is asking for problems when coordinating, interpreting and implementing, and which only serves to further delegitimise what is already a complex task: that of applying programmes for balance of payment support, bank recapitalisation and structural adjustments, as shown by the case history of the IMF.

The authors cite various factors explaining the ineffectiveness of the SGP, the nucleus of fiscal discipline within the EMU. Firstly, and on the subject of prevention, we underestimated the positive effect of the cycle on public finances, allowing for excess expenditure during expansions. Secondly, debt thresholds were completely ignored, despite these being critical to the sustainability of public accounts. Thirdly, the envisaged disci-

[17] For readers with a special interest, chapter 7 of the 2014 Yearbook provides an in-depth review of the fiscal governance reform process in the euro area and in the European Union itself.

pline mechanisms were not used, meaning incentives and sanctions were never applied. Fourthly, national budgetary frameworks often failed to address SGP obligations. And fifthly, the timeliness at which national statistics were released and their quality left a lot to be desired. The recent reform of the SGP aims to address these weaknesses by: (i) strengthening the preventive arm with an expenditure cap; (ii) granting the Commission authority to evaluate national budgets in advance; (iii) attaching greater importance to debt requirements in relation to the corrective arm; (iv) offering the Commission better and more timely fiscal information; (v) bolstering the system of sanctions and increasing its automatism; (vi) requiring countries to transpose their European fiscal commitments into national law; and (vii) adding a new player to the budgetary process, namely the Independent Fiscal Authorities, in the case of Spain the AIReF[18], which will operate under the «comply or explain» approach when issuing recommendations.

A set of widely known institutional developments to be sure, in the sense that nothing new has really happened this year on the subject of fiscal governance, and in relation to which there is «widespread consensus that greater changes are needed», as the authors themselves acknowledge. In this context, we have the Five Presidents' Report and the Commission Communiqué of October 2015. For the purposes at hand, the report underscores the need to progress towards «a budgetary union that delivers both fiscal sustainability and fiscal stabilisation». A specific and lofty objective that entails, in my opinion, the need to equip the Union with effective discipline mechanisms to ensure sustainability and a sufficient European stabilisation budget, or otherwise sufficient financial facilities, assuming this function could still be entrusted to the ESM. Please note also a subtle change in terminology, so as to not to get caught up in a debate on tax harmonisation or standardisation: what has until now been referred to as the fiscal union would be better described as a Budgetary Union.

To press on with this fiscal union, the report offers a roadmap with long but specific milestones: (i) an advisory European Fiscal Board to provide an independent fiscal assessment at European level; (ii) a common macroeconomic stabilisation function, warranted by the European Fund for Strategic Investments, widely known as the Juncker Plan, and for which we have included a specific appendix due to its importance; and (iii) a Euro area Treasury, which would fall squarely within what the report calls the Political Union and whose functions have yet to be specified.

The proposals on the fiscal union are discussed at greater length in the Commission's communication released in October. It calls for specific discussions within the Eurogroup on the tone fiscal policy should take (known as «fiscal stance») across the euro area. It also calls for the creation of a European Fiscal Board to assess the application of the fiscal discipline framework within the euro area and to come up with a suitable fiscal policy for the whole of the euro area. A board of five members, formally independent, though it would remain functionally attached to the Commission and not to the Council. This particular aspect has received considerable criticism and could delay the approval of the

[18] For a detailed analysis of the creation of the Spanish Independent Authority for Fiscal Responsibility (Autoridad Independiente de Responsabilidad Fiscal), see the relevant chapter of the 2014.

entire package, as it marks a further attempt by the Commission to win back ground previously lost to the Council, consistent with its intention to become the real governor of the euro area. The problem is that for as long as the Treaties remain unchanged, the Commission will lack democratic legitimacy, which rests with the Council. Yet it is interesting to note that the advances towards the budgetary and fiscal union have resulted in talk of a political union, as the EMU is already encroaching on the sensitive and central issue of state sovereignty. If we want to continue advancing, I see the reform of the Treaties as being a foregone conclusion and one that will need to take place in a much shorter timeframe than what many would like.

Still on the subject of the new framework of fiscal governance within the EMU, it is difficult not to agree with the conclusions reached by our authors, after duly explaining what we need to do in order to make further progress. First, the new framework is more complex and less transparent than its predecessor, making it more difficult to accept. Second, there is greater discretion in how to apply it and so it will ultimately depend on how the Commission and the Council decide to implement it. Third, its guidelines are excessively generic and this could cause problems when transposing the framework into national law. And their ultimate conclusion is something we have been at pains to point out since the very first edition of this Yearbook: a more far-reaching reform of the fiscal framework should be undertaken in order to streamline and simplify the system while making the task of applying it more automated. Moreover, the greatest limitation of the new fiscal governance framework is the fact that it is far from being a bona-fide fiscal union as it does not have a sufficiently strong common European budget and nor does it envisage common debt issues. All things said, achieving a fullyfledged fiscal union will mean introducing new discipline elements and even possibly forfeiting national sovereignty as a last resort. Only then will resistance to sharing risks disappear. Interestingly enough, this is a process relatively akin to the fiscal discipline and mutualisation followed by Spain on a regional level with the Regional Liquidity Fund and the Suppliers Fund following the reform of the Budgetary Stability Act.

Given the importance of the Juncker Plan, we asked Román Escolano, Vice-President of the European Investment Bank (EIB), one of the institutions spearheading its application, to help us explain the plan. Please see chapter 8 for his contribution to the subject. The President of the European Commission included the need to stimulate investment and enhance competitiveness within the EU as two of the priorities on his political agenda to be articulated through the «Investment Plan for Europe». The plan aims to mobilise additional investment of at least 315 billion euros, with the operative word being «additional». The main instrument here is the European Fund for Strategic Investments, or EFSI for short. It is essentially an accounting entry, without its own legal personality, for a grand total of 21 billion euros; comprising a 16 billioneuro guarantee from the EU budget and a five billion-euro commitment from the EIB. The EFSI offers first-loss protection to cover the credit risk of a portfolio of additional financing that the EIB expects to generate in the coming three years for a total value of roughly 60 billion euros. With this commitment of 21 billion euros, and subsequent EIB financing amounting to approximately 60 billion, the EFSI aims to mobilise investments in the aforementioned region of 315 billion euros.

The regulations of the EFSI were only approved in July 2015. The institutional architecture and corporate governance of the EFSI have yet to be fully defined. Yet the EIB has wanted to be proactive in implementing the fund and has been preapproving loans under the EFSI since April 2015. Approved transactions range from innovation and development in the pharmaceuticals industry to healthcare; and from renewable energies and energy efficiency to strategic infrastructures, embracing both large-scale projects and smaller investment plans for SMEs, from which over 65,000 companies hope to benefit. The fact that it will incur losses is an inevitable consequence.

I believe it could be a useful initiative for mobilising investments at attractive prices by leveraging the funding capacity of the EIB and its coveted rating. Yet we still need to create a genuine stabilisation mechanism for the euro area. The EFSI is more akin to an extraordinary investment fund intended to correct the investment shortfall in Europe; a kind of sel-ffinanced Marshall Plan that relies on smart financial engineering to resolve a temporary problem. It is also a prime example of the difficulties the euro area is facing in finding its own fiscal policy and of the adhoc mechanisms that are springing up to put off the inevitable move towards the Fiscal Union.

The turmoil in Greece marked the year 2015 in Europe, with everyone struggling to bring the country's monetary union obligations in tow with political reality. We asked José Manuel Amor and Víctor Echevarría, of Analistas Financieros Internacionales (AFI), to provide their assessment of the Greek crisis in chapter 9 and of the roles played by the European institutions. The chapter contains a chronological account of the Greek crisis since it first erupted back in 2008 and explains the events leading up to the climax seen in the summer of 2015, while also providing two conflicting interpretations of events, depending on whether Greece's problems are viewed as originating from within or from outside the country.

Those that contend that the crisis originated from within argue that the main reason for why Greek public accounts were in such a desperate state was the populist and irresponsible policies of the recent past, particularly the country's inability to overcome the deep-seated structural problems plaguing the Greek economy. I would add one more major reason to this: Greece's conscious or unconscious unawareness of the economic obligations assumed by voluntarily entering a monetary union and therefore forfeiting the right to use exchange rates as an adjustment mechanism, from an economy that had made exchange policy its main adjustment instrument. This version, the authors add, means accepting the packages put forward by creditors; packages they would later ditch quickly after making the mistake of believing fiscal consolidation would act as a growth lever. And too quickly, I would say, because they chose to undervalue the negative impact on investor confidence and therefore on the chance of recovering the investment and returning to growth, which was triggered by continuous breaches of the commitments assumed and the reliance on aggressive negotiation strategies, which even led to the discrediting of the negotiators themselves (the Troika).

Those who claim the crisis originated externally share the same ideas as the Greek left-wing; ideas that can be broken down into four: (i) the debt burden was already socially unsustainable at the start of the crisis and austerity only served to worsen the humanitarian problems; (ii) the initial adjustment programmes were a failure because

most of the money was used to pay off international creditors; (iii) the situation was wrongly viewed from day one as being a liquidity problem and not for what it was, a solvency problem; and (iv) the institutional design problems of the euro area were also to blame and, more specifically, the absence of internal automatic stabilisation mechanisms. Amor and Echevarría essentially share this same belief and contend that the only hope of recovery for the Greek economy, and implicitly for peripheral countries facing similar problems, such as Portugal and Ireland – although not expressly stating as much – is a significant reduction in external debt, meaning debt relief.

As readers of this Yearbook are well aware, I have always used the executive summary to offer my own personal interpretation of the contributions made by the different authors, while underlining their conclusions and providing a critical discussion of their findings, adding also any further points or clarifications I might deem relevant in order for the reader to form their own opinion on the matter. I believe this is the best way of getting our message across, particularly when approaching a topic of such magnitude. For this reason, I cannot help but disagree with the authors, as indeed I have let them know in person while they were preparing their article. I trust these discussions and differences will help you the reader as much as they have helped us.

Allow me therefore to provide a brief critique of the notion that the Greek crisis originated externally. Firstly, focusing on the country's intolerable debt burden ignores the fact that each and every adjustment programme included debt relief measures from the very outset; measures that traditionally feature repayment extensions, interest rate reductions or moratoriums on payments of principal or interest. Furthermore, the second rescue package specifically included (as mentioned in the chapter itself) a debt restructuring arrangement with private creditors, the upshot being that Greece's main creditors are now the IMF, the ECB, the European Commission and the governments of the euro area, some of which, incidentally, have per capita income lower than Greece. As a result of this restructuring, debt service in terms of GDP is currently lower in Greece than in many European countries, including others with programmes in place. Speaking of debt relief in this context effectively means seeking a transfer of income from European taxpayers to the Greeks. It also means questioning the preferential creditor status of the multilateral institutions and of the ECB, which perhaps we will have to do, but this still requires a detailed and indepth study, as we will do in the next chapter of the Yearbook, due to the collateral impact on the financial system as a whole.

Much of the money obtained from rescue packages is invariably used to repay private creditors, as otherwise they would never again invest in the country. Thus far, this has been the logic underlying all the structural adjustment programmes the IMF has implemented since its inception. Seeking to change the paradigm of sovereign defaults and attempting to replace it for one based on concessional aid and subsidies is a different issue, and indeed there are countries more entitled than Greece in this case. But what I am convinced we must focus on is why this external capital did not return, in stark contrast to similar adjustment episodes in Mexico, Korea, Indonesia, Portugal or Ireland; or why the successive Greek governments squandered all the opportunities they had to regain the trust of investors. Lastly, and while acknowledging that the monetary union is lacking an automatic stabilisation facility, as we have been endeavoured to highlight in

this Yearbook since it was first published, it is also equally the case that work has been ongoing since 2010 to complete the institutional design of the Union to the point where it is now glaringly obvious that without the ESM, the SSM, or the ELA discussed previously, Greece would have been thrown out of the euro a long time ago and forced to take up its own currency. It is also equally the case that without this same stabilisation mechanism, and without debt relief but with greater fiscal adjustments, other countries to have experienced a crisis, including Portugal and Ireland, have seen a return to growth and job creation.

Amor and Echevarría end their chapter by arguing for sovereign debt relief to ensure the stability of Greece and the entire Union, plus a change in the underlying approach of the bailout packages, which they believe should feature more measures aimed at stimulating and kickstarting the economy. What they are seeking is nothing new and has indeed been discussed domestically by all countries that have had to resort to the IMF. Perhaps we should listen to those economists in emerging countries who claim that only now are OECD countries realising their error of their ways after having to swallow such a bitter pill. But I still believe the main purpose of an adjustment programme remains the same: measuring the funding gap and estimating the available resources needed to seal it. If there are available funds and assuming the countries of Europe are prepared to subsidise Greece even further, the internal adjustment will be less pronounced. If the Greeks showed more willingness to cooperate with their creditors, instead of trying to turn them into unwilling benefactors, and if they would only honour the structural reform commitments assumed since the first programme without further delays, more debt relief would be forthcoming, which the Troika itself has been at pains to point out; because a mixture of external funding and internal adjustments is the only way of climbing out of a debt crisis, as indeed has been shown by the successful adjustment programmes implemented in Europe.

The ongoing debate surrounding the restructuring of European debt is addressed specifically in chapter 10 of this Yearbook by Ángel Ubide of the Peterson Institute for International Economics. We saw fit to entrust this study to somebody who, apart from having considerable expertise in the matter, could provide an international perspective allowing for a systemic discussion that transcends the European sphere of things. Sovereign debt in developed countries has reached an alltime high due to a combination of automatic stabilisers, discretionary counter-cyclical fiscal policies, mistakes in economic policy, financial system bailouts and low growth rates. In the case of Europe, the cracks in the institutional infrastructure of the monetary union have also aggravated the problem. Looking ahead to the future, the high levels of debt – weighted average of 93% of GDP within the euro area – will dampen growth further and increase the cyclical vulnerability of the affected economies. It can come as little surprise therefore that more and more are pushing for an orderly sovereign debt restructuring system[19] and that

[19] Something that already occurred in the wake of the Latin American and Asian crisis when the IMF proposed a Sovereign Debt Restructuring Mechanism, or SDRM for short. Following furious debate among academics, politicians and the industry itself, the mechanism was never enacted, mainly because it was then believed that it would significantly impair access to external funding and worsen lending conditions for potentially weak countries, which at the time were all emerging economies. The possibility of this affecting an OECD country was never envisioned.

supervisors are looking to apply positive sovereign risk weights to the debt holdings of financial institutions while limiting regional exposure to sovereign debt.

The chapter proposes an alternative approach, involving the active management of future debt service flows in order to advance towards the Fiscal Union. The idea seeks to minimise refinancing or rollover risk and the risk of a sudden drying up of capital flows towards those countries considered especially in debt, while at the same time maintaining market discipline and eliminating moral hazard.

Debt sustainability has become a key indicator in each and every external aid package, whether those commonly used by the IMF, which can only take part after confirming that the debt is highly likely to be sustainable, or the European Troika. Yet sustainability is an indefinite and unquantifiable concept. Countries with their own monetary policy can always print more money to pay off and settle their debts. Sustainability therefore coincides with their willingness to pay and with their political capacity to make the necessary internal adjustments. This essentially makes sustainability a political decision and the task of measuring it a discretionary extraeconomic exercise in how much internal adjustment the country is able to withstand. This raises inevitable problems of horizontal fairness, of international comparability and of moral hazard. Because countries more hostile to a market economy and with less of a payment culture would be the least sustainable and therefore the most likely to need debt relief. Within the European monetary union, the task of analysing sustainability becomes even more complicated as it requires a prior judgement as to whether the debt is in foreign or local currency and as to the likelihood of the debtor being forced or voluntarily deciding to abandon the euro.

The basis equation of the debt dynamic is well known. Sustainability essentially hinges on the balance between the primary surplus, growth rate and the level of interest rates. The author presents a simple example of this equation to illustrate how sensitive the sustainability of European debt is to alternative scenarios. It shows that the euro area is highly sensitive to a negative interest rate shock, something that perhaps explains the ECB's monetary policy despite the institution being perfectly aware of the associated costs, or to a new recession, as we have seen this year in Greece.

The institutional framework of economic and fiscal governance within the eurozone has improved considerably since the crisis first emerged. But for Ubide, the underlying problem remains: the inability to issue joint debt, to integrate fiscal capacity and to create a Treasury for the euro area. After discussing the various academic proposals on the table for issuing European debt with joint responsibility, including *ESBies, the redemption fund, blue and red bonds, eurobills or the PADRE,* the author ends up siding with his own alternative. For him, the real problem with European debt is that it is almost entirely in the hands of euro area residents – public agents, financial institutions and private investors. As a significant part of this in the hands of the ECB, the debt relief would hit the private sector the hardest – thus worsening the recession – unless the central bank were to take part in the deal, which would mean breaching the Treaty as it explicitly prohibits monetary financing of the deficit. Moreover, imposing limits on sovereign bonds held in the portfolios of financial institutions or applying sovereign risk weights (a real possibility that the ECB seems ready to implement as part of its supervisory functions) is considered especially problematic, as «not only would it increase the costs of

financing for already weak Treasuries but also reintroduce the risk of euro rupture and redenomination».

The Five Presidents' Report flags three guiding principles for a stabilisation function within the European Fiscal Union: (i) it should not lead to permanent transfers; (ii) it should incentivise sound fiscal policymaking at national level; and (iii) it should improve the resilience of the whole of the euro area and of the different Member States. All things said, every stabilisation fund proposal put forward for the EMU should combine elements of joint debt issuances with incentives to ensure national discipline. The chapter's author raises the idea of issuing stabilisation bonds across all maturities to finance up to 25% of domestic GDP and to be backed by shared fiscal income or even a new European tax. They would enjoy seniority over national debt and would be used to finance national budgets, although they could also be applied to a European investment programme to avoid the current slowing of the European fiscal pulse. Both the European stabilisation bonds and the national bonds could be bought by the ECB and eligible under its quantitative easing policy. The author is adamant this would bring down the average cost of debt for European countries, although it would slightly push up the price of national bonds. This is a crucial matter as there is the real danger that investors will react by considering that European solidarity (the implicit but hitherto effective mutualisation mechanisms) is limited to that same 25% of GDP and that anything beyond this should be treated as a junk bond, with a high likelihood of default in countries with weak treasuries. The proposal also fails to mention which European authority would be entrusted with the issuance of such instruments or the approach or procedure that should be followed so as not to get caught up in the complex institutional debate between the ESM and the Eurogroup. It is in any case an interesting proposal; an idea that finds support in the Five Presidents' Report and that seeks to provide the monetary union with stabilisation capacity on the path towards fiscal union.

The book concludes with a number of political reflections on the state of the Union. Because, as we have said, European monetary union is not just an economic or financial project, but a political one. This year we are featuring two very different articles. The first can be found in chapter 11 and explores the monetary union from the standpoint of emerging economies, because Europe has always aspired to be a soft global power; of becoming a model for stability and a benchmark for future integrations in other parts of the world. The second is contained in chapter 12 and examines the British referendum on whether the UK should remain within the European Union, precisely because we consider this the most important political challenge facing the EU. It is indeed a paradox that a monetary union conceived for advancing European political integration – «Europe will be built on money or not at all» – has become a ticking time bomb that could cause the union to implode.

Alicia García Herrero, of Bruegel, and David Martínez Turégano, of the Bank of Spain, compare the European Union with two of the most promising integration processes seen in the emerging world, namely the Association of Southeast Asian Nations, or ASEAN for short, and the recently created Pacific Alliance. For European readers not particularly familiar with the subject, the authors start out by describing the degree

of integration in both organisations and their immediate targets. They then discuss the extent of nominal and real convergence achieved and their potential for resisting exogenous shocks; one of the main weaknesses shown up in the original design of the EMU. It is not my task now to describe the process of integration in Asia Pacific but I would encourage readers to peruse this article as Europe suffers from Eurocentrism and many of the prevailing problems in the region are down to this. Using the trade relations yardstick (the most commonly used indicator), integration in the ASEAN stands at 25% and at just 5% in the Pacific Alliance, compared with 45% for the EMU, showing there is still a long way to go. Financial integration stands at 15% for the ASEAN and 3% for the Pacific Alliance, compared to 55% within the EMU. Interestingly enough, however, migratory movements between member countries are actually higher in these regions, reaching 55% in the ASEAN compared to 30% within the EMU, although these figures hide the total weighting of immigrants within the population and in the case of the monetary union are penalised by the fact that the United Kingdom falls outside its scope, with the UK being one of the main destinations for intraEuropean migration.

Applying the nominal convergence criteria set out in the Maastricht Treaty to Asian integration and comparing this with the European situation prior to the arrival of the euro reveals only slightly higher levels of heterogeneity, which would not appear to be enough in itself to warrant or advise against monetary integration. Moreover, if the insufficient levels of real convergence across the EMU have had a negative impact on the single policy, the same precautions should at least be taken in the case of the Pacific Alliance. Meanwhile the huge existing gulf is clearly preventing the ASEAN from creating an ideal monetary space. Despite some recent progress, the real divergences within both areas of Asian integration are having a huge effect on competitive conditions and productive structures, resulting in very different sensitivities to exogenous shocks, which become even more acute in the case of commodity exporting economies. In addition, the fact that their financial markets have no real depth to speak of and that some are hugely reliant on foreign currency would be major, if not insurmountable obstacles to implementing a single monetary policy and for stabilising their financial systems without a proper system of risk mutualisation from the outset. Yet these obstacles have not prevented either the ASEAN or the Pacific Alliance from continuing to make progress in many other areas of integration, which have resulted in improved levels of wellbeing. As we Europeans are gradually learning, a successful monetary union requires a commitment to banking union, financial union, fiscal union and economic union, and to do so we must be willing to forge a political union. Any other interpretation is and will always be a source of problems. And we should not assume that it will in itself pull things together in the right direction; a monetary union does not create an optimum monetary area on its own.

In chapter 12, Phillip Souta, Head of *Public Policy* at Clifford Chance, discusses the United Kingdom's possible departure from the European Union. He offers an unequivocal conclusion that goes beyond any prior stance or judgement one might have concerning the merits of such a move. An eventual Brexit would push the United Kingdom into a lengthy period of inescapable legal uncertainty and gloom with many unforeseeable consequences. Such is the degree of Great Britain's integration since 1973, that

much of its corporate, tax, employment, competition, consumer protection and of course commercial law stems from European law. Would British courts consider all this law still valid? Legal uncertainty that would inevitably have an economic impact and take up much of the time of the government, parliament and the judiciary time for various legislatures to come.

The chapter starts out by defining the United Kingdom's current status within the European Union; despite being a full member it has managed to opt out of certain areas such as the single currency, internal borders, Schengen, and various aspects relating to justice, home affairs and security. A status the author then compares with the possible alternatives. This might be of particular interest to Spanish readers in that it highlights the programmatic weakness of the «no» campaign; a negative approach followed by some in a bid to leave Europe but which fails to clarify what happens next. Probably because any attempt to do so would rob it of its mystique. Souta provides four possible scenarios, all based on real cases: the Norwegian model, the Swiss model, the Turkish model and a purely bilateral relationship.

Following the Norwegian model would essentially mark a return to the situation prior to adherence and would mean the United Kingdom remaining within the European Economic Area (EEA) and within the European Free Trade Area (EFTA). Let us not forget that it is an institutional balance that Great Britain itself already rejected as being insufficient; because it would have no effect on much of the socalled meddling from mainland Europe in the British way of life vis-à-vis –employment, the environment, consumer and investor protection, competition, State benefits, etc.– while at the same time the UK would forfeit its right to vote on the Council, its position on the Commission and its ability to influence and shape legislation that would instead be imposed on it unilaterally. This would raise special concerns in relation to the capital markets union.

The Swiss model would entail a relationship with the EU based on bilateral sectorspecific agreements arranged on a casebycase basis. A relationship the Commission has already branded unsatisfactory, in need of improvement and merely a temporary solution. There would appear to be little chance, therefore, of the same relationship being accepted in the case of the UK. All the more so when we consider that the EU has insisted in the almost anecdotal case of Switzerland that the four freedoms of the European Union – goods, services, capital and people – are indivisible and that «social dumping» is incompatible with access to the European market.

The Turkish model – a simple customs union – essentially limits relations with the EU to a free trade agreement with the obligation to unilaterally accept the common external tariff and the State's aid regulations. The UK would forfeit the right to provide services, including financial services, under equal conditions with any other member state. This kind of agreement is best viewed as a threat, a kind of EU bargaining chip, rather than an actual possibility for the UK. Which leads us on to the final scenario whereby Great Britain leaves the EU, thus necessitating a complex negotiation process to set up a bilateral trade agreement between both regions. The results of this path are difficult to discern and we would be wise not to underestimate the ramifications of the considerable political and human distancing this would entail. In this eventuality, bargaining power, interest in the deal, urgency and even the need to conclude an agreement would not be

distributed equally among the two parties. Europe will be worse off, less free and less prosperous without the UK, of that there is no doubt. Yet it has been without the UK for many years. The United Kingdom would be a less coveted international partner without its status as EU member, while the benefits of its geographical location would become less important and its legal and regulatory framework – currently one of its greatest assets – may become a hindrance or obstacle if it distances itself too much from the European model. The economic cost-benefit analysis is unquestionable.

3. THE FIVE PRESIDENTS' REPORT AND THE TEN LESSONS EUROPE LEARNT DURING THE YEAR

Ever since the first analysis of the euro for Fundación de Estudios Financieros, I have attempted to round off this executive summary with a list of ten lessons we have all learned in Europe. The aim here is to provide an outline of the ten tasks we consider most important or pressing in order to continue consolidating the monetary union and therefore ensuring that it is irreversible. But also to ensure its acceptance and legitimacy by the people, because as with any political processes, the venture will only last if the citizens of Europe feel engaged, appreciate its utility and recognise its benefits. Let us now go over the ten lessons learnt this year.

One: the euro continues to gain weight as a regional currency and as an international reserve currency. But it has no chance of replacing the dollar as whether a currency becomes an international reserve currency depends on multiple economic, political, institutional and strategic factors and is extremely resilient to change. Moreover, use of the Chinese currency, the renmimbi, is likely to increase in the short term following its inclusion in the basket of Special Drawing Rights of the IMF and given the gradual capital account liberalisation. In these conditions, a reasonable challenge for the euro would be not to lose its share in trade finance; already a lofty target seeing as though euro area trade is already losing ground. Attempts should also be made to make slight improvements to the euro's share in financial transactions and as a reserve deposit, which will depend on its perceived stability and the continuity of the monetary union.

Two: all financial fragmentation indicators in the monetary union – measuring both price and volume – have improved in the past year, despite sporadic episodes of instability sparked by the Greek crisis. What's more, the improvements have been particularly impressive in market segments of special importance to Spain and other peripheral countries, such as the retail markets. Yet levels of integration are still a far cry from the levels seen before the crisis struck in 2008, suggesting that the change in the behaviour of market agents might be here to stay, especially their increasing risk aversion and domestic bias. Their expectations have changed persistently, perhaps also due to a distancing from the process of European integration and the reluctance shown by some of the traditional proponents thereof. To progress with financial integration across Europe, we need to break out of our conformist inertia, clear up the lingering doubts over the path towards bank and sovereign debt mutualisation in Europe, and stride purposefully towards a fiscal union and a capital markets union. Looking ahead to 2016, the outcome of discussions on the European Resolution Fund and bank deposit insurance and final

acceptance of the Commission's proposal, which is not particularly ambitious in itself, would appear to be critical if we hope to build upon existing levels of integration.

Three: the ECB's unprecedented monetary policy has been a success. Yet it remains an extraordinary, emergency policy. It has prevented the debt crisis from imploding and has helped patch up the institutional flaws in the design of the monetary union. But it has done so at the risk of granting the European Central Bank an excessive central policy role, forcing it to adopt quasifiscal decisions and placing it firmly in the midst of the controversy, which may jeopardise its independence. If this extremely heterodox monetary policy persists for too long, it runs the risk of generating perverse incentives, thus postponing the inevitable deleveraging of public and private agents, families and companies – for Europe has incurred excessive debt – and delaying the structural reforms that could trigger increased productivity. For this reason, the main challenge facing the ECB is now to ready the region for the impending break from abnormally low interest rates and guaranteed liquidity, paying particular attention to the negative impacts on the financial system; impacts that will be all the more severe due to a prudential and regulatory policy that seems to sit uncomfortably with the current cyclical positions in Europe.

Four: the ECB's new role as a bank supervisor has unquestionably been a success. In very little time at all, it has set up a team, a framework and a supervisory methodology across Europe. Although regulatory exceptions at national level still persist, the new framework has done a good job at levelling the playing field and has improved comparability of bank balance sheets and profit and loss statements. It has led to an extremely important cultural change across many markets and an enormous workload for financial institutions, which have had to adapt to conceptual supervisory approaches far removed from the ones they were used to. But the speed of the regulatory change has been excessive. Financial institutions need stability to be able to plan and take strategic decisions in relation to capital, governance and business models. At the same time, the new supervisory model has increased the supervisor's discretionary authority; authority that must be accompanied by transparency, predictability and accountability. As supervisor, the ECB faces the same legitimacy problem as it does as monetary authority, yet it does not appear to be fully aware of the problem.

Five: the banking union requires a functional and effective single European Resolution Mechanism and Fund. Their notable absence is probably the main reason why the debt crisis has gone on so long across the continent and has generated a vicious circle of banking and sovereign crisis. Yet the regulations enacted so far leave too many questions unanswered. Three of these, in my opinion, are threatening to make the union a dangerous venture: (i) the timeframes for mutualisation are excessively long, although it is true that the markets are confident the process will be streamlined should this prove necessary; (ii) the fund is too small and, above all, the capacity to assume debt is extremely limited and subject to too many conditions; and (iii) there are excessive restrictions on the fiscal backstop, and without it no resolution mechanism can be fully reliable. No fiduciary financial system has ever worked without being ultimately backed by the State. The reluctance to commit European taxpayer money is understandable, particularly in the wake of the recent excesses we have seen and with clearly insufficient fiscal discipline mechanisms in place, but this fact does not justify a return to inconsistent and unsustainable visions of monetary union.

Relying on the Resolution Mechanism, or the European Deposit Guarantee Scheme, as a second chance to rewrite the banking union is irresponsible and reveals excessive complacency from the currently benign state of the financial markets.

Six: moving forward with the capital markets union will not be an easy task, but one we must undertake if we hope to put an end to financial fragmentation and the domestic bias of investors and market operators, and also consolidate the monetary union and use of the euro. It is also an absolute must in order to guarantee the preeminence of European financial markets against a backdrop of growing delocalisation and globalisation of savings. It means harmonising multiple national legislations, and affects the vested rights of debtors and creditors alike, deeply rooted practices and traditions and the currently highly disparate rights of consumers. Beyond the rhetoric commonly used, making significant progress seems a difficult prospect without first securing major political support for proceeding via European legislation, meaning Directives and Regulations. It entails relying on ample political capital on a matter that has attracted little attention from the population. But without this political leadership, which the Commission appears to have assumed, we will never see any relevant impact.

Seven: we have witnessed significant progress in terms of fiscal governance within the monetary union and this has undoubtedly served to strengthen the discipline imposed by European institutions, as indeed we saw with the Greek political crisis in the summer of 2015. Yet the general public at large cannot understand the progress made and moreover it has not been enough to satisfy the academic and investment communities. For the public at large, this lack of understanding undermines the democratic legitimacy of the European system, which is particularly important on matters of fiscal sovereignty, as we saw once again in the case of Greece. It must also be simplified drastically if it is to be understood and scrutinised by the population. For investors and academics, what they see as limited progress makes it less credible in the eyes of the market and fails to answer the question as to the degree of future integration of the Union and therefore its sustainability. In order to progress with the fiscal union, we need to develop a European stabilisation function and a Treasury function: issuing some kind of European instrument. Yet above all we need to define a specific model for sharing risk and ensuring fiscal discipline; one that ultimately envisages the loss of sovereignty.

Eight: the restructuring of European debt is no small matter. There is no proper mechanism in place, and nor is there any sign of one on the near horizon. There is no comparable international mechanism and the IMF's efforts to design one have thus far been ineffective. It is not even clear Europe needs one, with a good system of fiscal governance that includes a macroeconomic stabilisation fund. A system of almost complete national fiscal autonomy with no European bailout mechanisms is theoretically possible. In fact, this was the original blueprint in the Maastricht Treaty. Yet experience has told us that this is not viable because it threatened to bring down the monetary union. A more reasonable alternative is a system that limits the fiscal autonomy of the parties in exchange for a bailout mechanism subject to strict conditionality. Because making sovereign credit events more frequent and less costly raises serious problems by creating perverse incentives and posing difficult distribution decisions. It would mean granting the supranational authority in question(whether it be the ESM, the

Commission, or the Eurogroup) the power to take control of the sovereign assets and apportion them among the creditors with the relevant debt relief agreed upon. It fails to avoid the problem of having to decide on how best to make the internal adjustments and distribute external funding and threatens to structurally raise the cost of funding in those countries that could default on their obligations again. For the same reason, the ECB should rethink certain initiatives that look to penalise sovereign debt holdings on bank balance sheets; especially given the lingering degree of financial fragmentation.

Nine: the European Union has always been a model from which many other integration processes in the world have drawn inspiration. Whether this will continue remains unclear, given the unsatisfactory economic results of the Union and its inability to overcome the effects of the sovereign debt crisis. Monetary unions are not in fashion because the European experience has shown how difficult it can be ensuring the levels of coordination, harmonisation and economic and political integration needed to make a union viable and sustainable. The cost of trying to speed up monetary integration in other parts of the world, which, as we have seen, have fallen well short of meeting the necessary levels of nominal and real convergence, can be very high indeed. Each integration process has its own rules and takes its own time, depending on how realistic it is internally to bring about economic and social integration.

Ten: Brexit is one of the main challenges facing the European Union in the immediate future, because it reveals the potential reversibility of the union and the political costs of every single integration process. The UK's membership of the European Union is unquestionably beneficial from an economic standpoint; none of the options on the table for future relations with Europe would offer the UK the same level of access to the European market and the protection of rights. And the same could be said of any other member state. However, the appeal of separation is unquestionable for a significant part of European society. It is not exclusively a British problem, although the British government is the only one to have announced a referendum on the matter and also to have used this as a bargaining chip to gain concessions due to what it views as excessive risks associated with the monetary union. A decision that is risky but sovereign. Because the fact is that increasing pressure from Europe for national governments to give up sovereignty has caused considerable malaise in many countries. In many ways this type of protectionist reaction to any kind of social change and to the distancing of decisionmaking power was inevitable. But it is also largely down to Europe's inability to explain the changes, to raise awareness of the political implications and show proper leadership, to acknowledge and resolve the lack of sufficient democracy within the monetary union, and to modify the Treaties accordingly. It has taken us many years, until the Five Presidents' Report, to officially recognise that the monetary union is a political venture and requires political institutions to grant it democratic legitimacy. This has been Europe's most important lesson in 2015.

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1. A CLOSE LOOK AT THE ROLE OF THE EURO ACROSS THE WORLD

Carlos Poza Lara[1]

EXECUTIVE SUMMARY*

Despite slow recovery in the Euro Area (EA) and the tail risks in Greece during 2015, the Eurozone continues to incorporate a new Member and the euro shows a sound behavior in international transactions. In particular, Lithuania joined the Economic Monetary Union (EMU) in January 2015, raising Member States to 19, and the euro remains the second currency in the world and the first in Europe.

This chapter studies the use and role of the euro in the international economy from three points of view: the euro as a means of exchange, the euro as a store of value and the euro in financial markets. The main results can be summarized as follows:

- The strong nominal depreciation of the euro against the dollar that began in 2014 continued until April 2015, when it stabilized in at about 1.1€/$. The negative interest rate spreads in EMU with respect to the US largely explain the weakness of the single currency. By contrast, the euro has gained value against the renminbi due to the worsening of economic growth expectations in China and its consequent easing monetary policy.
- In relative terms, the use of the euro in extra-EA transactions stagnated, both in the case of exports and imports of goods and services (2014). However the use of the euro increased, in absolute terms because of the rise in intra-Euro area transactions (4.1%) and exports and imports in the Eurozone to / from destinations outside the Area Euro in 2014 (7.6% and 3.7%).
- Greece continues with low percentages of use of the euro in international trade (around 30% in merchandises and 35% in services). Furthermore, in the case of goods we can observe a bear trend since they are increasing international trade with Russia, Iraq and Kazakhstan (2015).
- The share of the euro in foreign exchange reserves, at constant prices, decreased slightly in 2014, chaining 5 consecutive years of decline. But it still remains a distant second, far behind the dollar, which continues in its dominant position. Nevertheless, the dollar has recently lost some weight against the yuan.

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[1] Associale Professor of economic analysis.

* Full report in the Spanish version «Euro Yearbook 2015» available in www.fef.es and www.fundacionico.es

– The number of countries whose currency is explicitly pegged to the euro has not changed in 2015, except in two important cases: 1) Lithuania joined the Eurozone in January 2015 and 2) Switzerland lifted the minimum exchange rate of CHF1.20 per euro at the beginning of 2015, a level that was introduced in 2011 to control Swiss franc appreciation.
– To date there are five economies with no separate legal tender regime (euroisation): Andorra, Kosovo, Monaco, Montenegro and San Marino, and two others that follow a strict currency board regime: Bosnia and Herzegovina and Bulgaria. In addition, there are 34 countries that use some other types of exchange rate system pegged to the euro.
– The ratio of deposits denominated in euros to total deposits in the world fell in 2014 at constant exchange rates, because of the tail risks arising from a possible Greek exit, the rise in emerging country currencies and the negative level of the Euro Overnight Deposit established by ECB in July 2014.
– Euro loans to total loans in the world decreased in 2014 at constant exchange rates, while those denominated in yuan soared within the same period.
– Confidence indicators in the euro (euroisation index and net shipments of euro banknotes to destinations outside the Eurozone) point out that countries in Eastern Europe continue their gradual process of linking its economies to the euro.
– The role of the euro in financial markets remains secondary to that of the dollar: this last currency continues to lead the market capitalization by currency. Also, the percentage of international debt denominated in euros to total debt registers six consecutive years of decline and the dollar broadly leads this market. TARGET2 confirms its leadership in the European flow of funds market and ranks third in the world by volume behind CLS and Fedwire. The euro is largely the second currency most used in forex, behind the dollar which maintains its «exorbitant privilege». Moreover, the latest figures show that the single currency participates more frequently in forex than in previous years; and in the OTC interest rates derivatives market, nearly half of the contracts are held in euros.

In summary, the most noteworthy news about the euro are the consolidation of European integration, the new enlargement of EMU and the soundness of the single currency in spite of the tail risks in Greece. Thus, regardless of doubts concerning Eurozone success, the figures show that this dynamic monetary area is growing and new countries from Eastern Europe are joining. Therefore, once again we must conclude that the euro is widely used as a regional currency but it is not still fully established as a global currency.

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2. HOW FINANCIAL FRAGMENTATION HAS CHANGED IN 2015

José Ramón Diez Guijarro[1]

EXECUTIVE SUMMARY*

This paper analyses the evolution of financial fragmentation in the Eurozone in the various segments of financial market, starting with wholesale finance, money and public and private debt markets and moving on to retail banking markets. On the whole, fragmentation indicators in Europe have improved continuously over the last two years, rebounding to close to pre-sovereign debt crisis levels. Price dispersion has decreased significantly, volumes are up, and in some markets such as the money markets, home-bias has fallen.

The greatest progress has particularly happened in some segments of the wholesale financial markets that are very important to Spain. Since mid 2013, the group of countries that faced major headwinds (Spain, Italy and Portugal) have seen an average 170-basis point reduction in interest rates for new credit to small enterprises (loans of less than 1 million euros) compared to one of only 40 basis points in Germany. The improvement has been especially pronounced in the case of Spanish small and medium enterprises, which have enjoyed a reduction in the cost of credit of around 200 basis points since mid 2013. As a result, the extra financial cost in relation to their German counterparts narrowed from over 200 basis points in 2013 to less than 60 basis points in September 2015. These levels reflect the significant impact of TLTRO in opening up SMEs' access to bank finance in countries such as Spain, or Italy. Moreover, this improvement was not significantly interrupted during the periods of greatest stress at the time of the Greek government-debt crisis, highlighting the robust nature of the shift in fortunes and discrimination shown by the markets.

Thus, the new measures implemented by the ECB, such as quantitative easing or the TLTRO programme, have played a decisive role in driving the decrease in financial fragmentation in the Eurozone. From here on, potential further improvements will be likely linked with structural developments in the European construction process and/or the management of a number of new risks, such as declining liquidity in some market segments. It will therefore be necessary to monitor closely how fragmentation can be affected by episodes of extreme volatility in certain financial markets, such as those experi-

[1] Director of Studies of Bankia and Professor at IE Business School and CUNEF.

* Full report in the Spanish version «Euro Yearbook 2015» available in www.fef.es and www.fundacionico.es

enced last year. The main assumption being that the exceptional liquidity conditions in money markets and bond purchasing by central banks will reduce the visibility and hinder the management of this risk.

In summary, although it appears that fragmentation is finally being curtailed, there is still a long way to go before the intended goal of robust and irreversible financial integration in Europe is accomplished. This challenge will require further work on fully developing the Banking Union and other complementary institutional initiatives such as the Capital Markets Union and keeping a closer eye on possible new sources of instability. The proposal to create a Capital Markets Union presented in February 2015 forms part of this effort and aims to break down the barriers inhibiting cross-border investments in the European Union and restricting companies' access to finance. The proposals focus on opening up alternative non banking sources of financing for the real economy, fostering efforts to raise capital, facilitating debt issues for SMEs, and developing new lending schemes such as crowdfunding and venture capital.

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3. MONETARY POLICY IN 2015. ANALYSIS OF THE CONTENT AND EFFECTS OF THE EXTRAORDINARY MEASURES

Blanca Navarro Pérez[1]

EXECUTIVE SUMMARY

The real protagonist in 2015 with regards to monetary policy in the euro area has been the announcement and implementation of the Expanded Asset Purchase Programme. Prior to this announcement, the unconventional measures of the European Central Bank (ECB) focused on providing abundant liquidity to the banking sector in the expectation that it would filter down into the real economy in the form of new loans to households and businesses. However, the unusual financial situation of many institutions (with balance sheets in need of consolidation) and the macroeconomic situation at the time prevented the ECB's monetary stimulus from filtering through to the desired extent, forcing the monetary authority to consider a change of approach. The year could therefore be considered as the moment when the approach changed from being 'banking focused' to a 'direct intervention' approach.

The ECB's monetary policy decisions need to be seen in a global context. In other economic areas, especially the USA (and to a lesser extent the United Kingdom), the debate is focused on the strategy for exiting exceptional measures. Europe is still in the phase of implementing quantitative easing.

The transition to a 'direct perspective' includes targeted longer term refinancing operations (TLTRO), which took full effect in 2015 and were intended to improve the transmission of the extremely loose monetary policy to the real economy by incentivising banks to lend more, although their quantitative effect was predicted to be modest from the outset. TLTROs, which were the ECB's central measure in 2014, continued to work in 2015 with the aim of incentivising greater lending in exchange for cheap funding for the banks. However, their ineffectiveness led to the real step forward with the announcement and implementation of the expanded asset purchase programme, which breaks new ground by including the purchase of government securities and involves a change of approach from the unconventional measures applied up until that point.

Interest rates were effectively as low as they could go and it was evident that the measures to provide the banking sector with liquidity were failing to achieve the ECB's objec-

[1] Blanca Navarro Pérez is Chief Economist at ICO.

tives by themselves. Consequently, in the last few months of 2014 inflation expectations clearly began to diverge from the desired levels. The ECB's commitment to adopting all measures within its mandate, where necessary, required the institution to adopt new measures, since the existing programmes did not allow the balance sheet to expand sufficiently to achieve its objectives. The ECB was being asked by various sides to take bolder action, with American-style debt purchases.

So, in September 2014 the ECB announced its intention to increase its balance sheet to the levels of early 2012, which meant ambitious quantitative easing which had not been achievable with the instruments in effect at that time. That led to the announcement in January 2015 of the start of the expanded asset purchase programme, with monthly purchases amounting to 60 billion euros, which would be extended until at least September 2016. In reality, there are three complementary programmes, two of them already in effect[2] (ABSPP and CBPP3), for the purchase of asset-backed securities and covered bonds, respectively, and the third (PSPP), a genuine departure, to purchase public sector securities. The purchase of these public assets, which is an essential part of this package of measures and represents direct intervention in government debt markets without the intermediation of the banks, began in March.

The aim of this quantitative easing is to reduce asset yields in the markets in which the purchases are made as well as in other markets due to the expected restructuring of portfolios, so that monetary stimulus is ultimately transferred to the real economy. The ECB's credibility has been boosted, giving agents more confidence in this new action.

During the course of this year, instability re-emerged in Greece, which forced the ECB to make certain decisions about what was –in principle– a purely technical instrument, Emergency Liquidity Assistance (ELA).

All of these measures, and the new outlook achieved by Draghi by setting a target volume of assets for the ECB, have had their effects on financial markets and the real economy. In brief, the announcement caused the expected reduction in yields and increased inflation expectations, although its actual implementation has caused a certain amount of correction, a situation which was accentuated by the repricing process that began before the summer in light of the uncertainties coming from emerging countries and China in particular. The exchange rate is another of the variables most directly affected by this new move by the ECB and the euro depreciated against the dollar with the announcement and implementation, although there has been a subsequent partial correction due to various other factors.

The strategy of significantly expanding the balance sheet is not risk-free and its effects will have to be assessed in the coming months. Some commentators doubt whether the impact on yields will end up affecting household and business spending and therefore inflation. Other risks relate to the possible creation of bubbles or certain agents taking excessive risks.

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[2] After the closing of this publication, the ECB approved new measures, consisting basically in the extension of its asset purchase program, at least until March 2017, and also in a deposit rate reduction leaving it at -0.3%. Those new measures do not distort the basics of the guidance mentioned during the article.

Lastly, the main challenge which the ECB will have to face in the coming years –as is occurring in other economic areas where the monetary expansion process is more advanced– will be the implementation of an exit strategy, in other words, a strategy to reduce the balance sheet that does not create distortions in the markets or compromise other objectives such as economic growth.

3.1. FULL REPORT

The star measure for 2015 with regards to monetary policy in the eurozone has been the announcement and implementation of the Expanded Asset Purchase Programme. Prior to this announcement, the unconventional measures of the European Central Bank (ECB) focused on providing abundant liquidity to the banking sector in the expectation that it would filter down into the real economy in the form of new loans to households and businesses. However, the unusual financial situation of many institutions (with balance sheets in need of consolidation) and the macroeconomic situation at the time prevented the ECB's monetary stimulus from filtering through to the desired extent, forcing the monetary authority to consider a change of approach. The year could therefore be considered as the moment when the focus changed from being 'banking focused' to a 'direct intervention' approach.

The ECB's monetary policy decisions need to be viewed in a global context. In other economic areas, especially the USA (and to a lesser extent the United Kingdom), the debate is focused on the strategy for ending exceptional measures. Europe is still in the phase of implementing quantitative easing.

The transition to a 'direct perspective' includes targeted longer term refinancing operations (TLTRO), which took full effect in 2015 and were intended to improve the transmission of the extremely loose monetary policy to the real economy by incentivising banks to lend more, although their quantitative effect was predicted to be modest from the outset. TLTROs, which were the ECB's central measure in 2014, continued to work in 2015 with the aim of incentivising greater lending in exchange for cheap funding for the banks. However, their ineffectiveness led to the real step forward with the announcement and implementation of the expanded asset purchase programme, which breaks new ground by including the purchase of government securities and involves a change of approach from the unconventional measures.

Interest rates were effectively as low as they could go and it was evident that the measures to provide the banking sector with liquidity were failing to achieve the ECB's objectives by themselves. Consequently, in the last few months of 2014 inflation expectations clearly began to diverge from the desired levels. The ECB's commitment to adopting all measures within its mandate, where necessary, required the institution to adopt new measures, since the existing programmes did not allow the balance sheet to expand sufficiently to achieve its objectives.

The ECB was being asked by various sides to take bolder action, with American-style debt purchases.

Furthermore, the reported intention of returning the ECB balance sheets to early-2012 levels called for the implementation of ambitious quantitative easing as announced: monthly acquisitions of €60 billion until at least September 2016[3] in order to reduce the profitability of assets from markets in which the purchases are made as well as in other markets due to the expected restructuring of portfolios. The ECB's credibility has been boosted, giving agents more confidence in this new action.

It mustn't be forgotten that instability re-emerged in Greece, which forced the ECB to make certain decisions about what was -in principle- a purely technical instrument, Emergency Liquidity Assistance (ELA).

All of these measures, and the new outlook achieved by Draghi by setting a target volume of assets for the ECB, have had their effects on financial markets and the real economy. In brief, the announcement caused the expected reduction in yields and increased inflation expectations, although its actual implementation has caused a certain amount of correction, a situation which was accentuated by the repricing process that began before the summer in light of the uncertainties coming from emerging countries and China in particular. The exchange rate is another of the variables most directly affected by this new move by the ECB and the euro depreciated against the dollar with the announcement and implementation, although there has been a subsequent partial correction due to various other factors.

The strategy of significantly expanding the balance sheet is not risk-free and its effects will have to be assessed in the coming months. Some commentators doubt whether the impact on yields will end up affecting household and business spending and therefore inflation. Other risks relate to the possible creation of bubbles or certain agents taking excessive risks.

Lastly, the main challenge which the ECB will have to face in the coming years -as is occurring in other economic areas where the monetary expansion process is more advanced- will be the implementation of an exit strategy, in other words, a strategy to reduce the balance sheet that does not create distortions in the markets or compromise other objectives such as economic growth.

3.2. EUROPEAN MONETARY POLICY IN A GLOBAL CONTEXT: DIFFERENT RHYTHMS AND EXIT STRATEGIES

2015 has served to confirm that the world's main central banks are taking very different approaches to monetary policy.

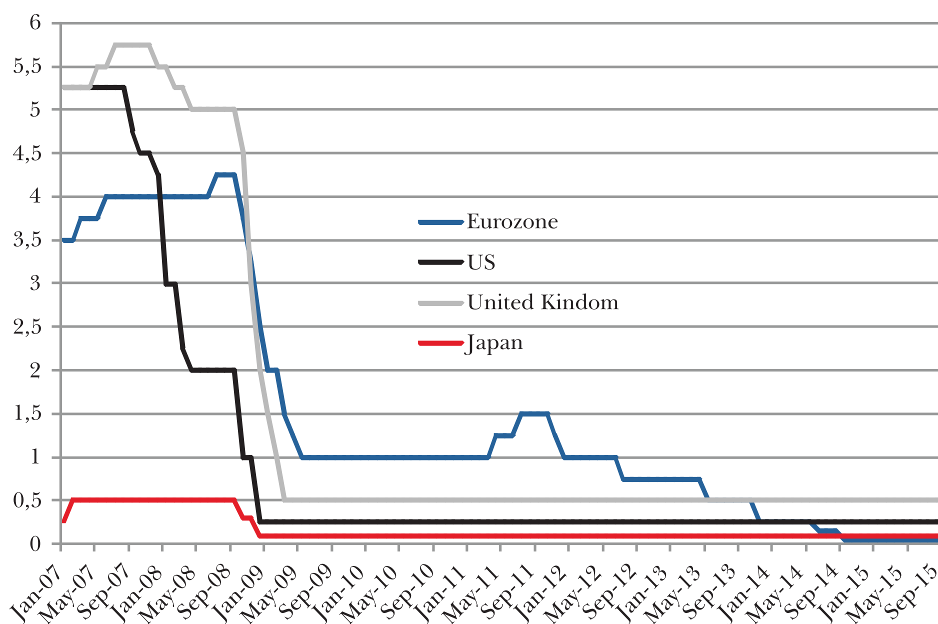
A mere glance at the main refinancing rates (graph 1), which show that all central banks have remained within the range of 0 and 0.5% since May 2013, would seem to sug-

[3] After this yearbook was sent to print, the ECB approved new measures that basically consist of extending its asset acquisition programme until at least March 2017 and reducing the deposit rate to -0.3%. These new measures do not significantly affect the approach taken throughout this article.

gest that they are all currently applying similar approaches in terms of their corresponding policies. In reality, nothing could be further from the truth, as there is a growing disparity in monetary policy, which will be exacerbated further after the expected increase in rates in the US (and presumably in the United Kingdom). In any case, central banks remain at the heart of economic recovery policies, as has been the case since the start of the Great Recession.

The aforementioned disparity in momentum in terms of the activities undertaken by central banks could be seen once again at the end of August 2015 in the annual meeting of central bank governors held in Jackson Hole (Wyoming, USA). At this meeting, despite concern for the situation in China, it was confirmed that the moment had arrived to raise interest rates in the US: 'we should not wait until inflation is back to 2 percent to begin tightening'[4]. Although less imminent, the situation is similar in the UK: 'the prospect of sustained momentum in the UK economy […] will likely put the decision as to when to start the process of gradual monetary policy normalisation into sharper relief around the turn of this year'[5].

GRAPH 1. INTERVENTION RATES OF THE MAIN CENTRAL BANKS

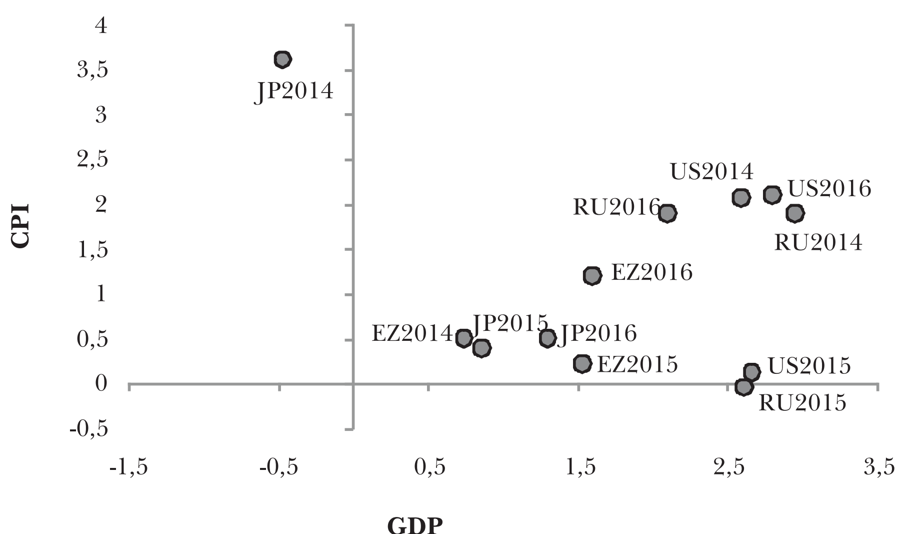


Source: ECB, Federal Reserve, Bank of Japan, Bank of England.

[4] Speech made by the Vice Chairman of the Federal Reserve, Stanley Fisher.
[5] Speech made by the Governor of the Bank of England, Mark Carney.

Therefore, in response to the different macroeconomic circumstances in the main economic blocks, whilst the ECB and Bank of Japan implement expansive monetary policies that seek to strengthen an economic recovery that fails to reach the desired pace, the US Federal Reserve and the Bank of England are, to different extents, moving away from the expansionary policies implemented during recent years in response to macroeconomic indicators that are responding more positively than seen in the eurozone and Japan.

GRAPH 2. GDP AND INFLATION IN THE MAIN ECONOMIC BLOCKS IN 2014, 2015 AND 2016 (IMF FORECAST)

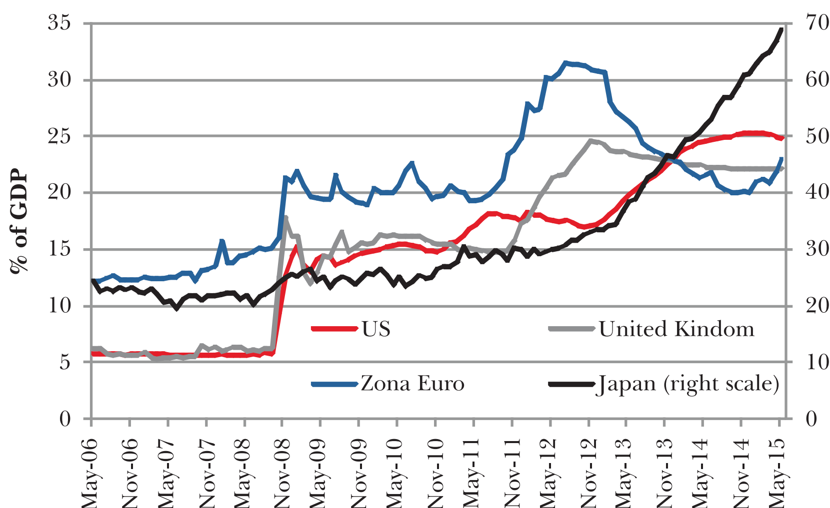


Source: International Monetary Fund.

In effect, graph 2 demonstrates that both the United States and the United Kingdom are shifting from a position of relatively high growth in 2015 (in both instances, above 2.5%) with practically no change in prices, towards growth that would remain above 2% for both countries in 2016, but with inflation of around 2%. On the contrary, in 2015 and 2016, both the eurozone and Japan are expected to see much slower rates of growth in terms of activity than the US and the UK, albeit with lower variations in price.

On the other hand, to illustrate the different paces at which each central bank is taking action in response to the different circumstances in each economic area, the evolution of accumulated balances is probably the most representative indicator.

GRAPH 3. BALANCE SHEET OF THE MAIN CENTRAL BANKS (SHOWN AS % OF GDP)



Source: Federal Reserve, Bank of England, ECB, Bank of Japan.

In 2015, there was great expectation as to what the **US Federal Reserve** would do. As it ended its new asset purchase programme in October 2014 and considering the improvement in macroeconomic data, there has been constant debate about when, and at what pace, official interest rates would increase. This is attributable to the fact that said interest rates have remained between 0 and 0.25% since December 2008, shortly after the international financial crisis began.

As we approach the time at which US monetary policy is to change, combined with Janet Yellen becoming the Chair of the Federal Reserve, has resulted in a shift in communication policy from a strategy centred on guiding expectations (in an attempt to increase the predictability of decisions to a maximum) towards a policy that places greater emphasis on analysing the circumstances at the time (macroeconomic data), which supports decisions.

The appearance of significant doubts in terms of the true situation in China over the summer and the weakness of other emerging countries was key to the Federal Reserve deciding to leave interest rates unchanged at its September meeting. In fact, in the press release following its 16-17 September meeting, the Fed expressly stated that 'recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation', thus indicating that the decision had primarily been influenced by international circumstances ('the Committee continues to see the risks to the outlook for economic activity and the labor market as nearly balanced but is monitoring developments abroad'). Furthermore, the outflow of capital from China seen in recent months as a result of growing uncertainty regarding the

country's future would have a similar impact in terms of the inflow of capital in the US; this could result in an increase in interest rates[6], with pressure to increase interest rates thus alleviated, and not only on account of global economic risks.

Based on this decision, market consensus places the expected increase in rates at the end of 2015 (presumably in December); however, should doubts regarding China and other emerging economies remain or intensify, it may be put back to the first half of 2016. In any case, it is expected that there will be an upward trend in the evolution of reference interest rates in the medium term, with 2016 seeing several interest rate rises, although it is not expected that any will be significant.

Thus, in 2015, the Federal Reserve has applied caution by leaving interest rates unchanged for the large part of the year; however, it has also done so by preserving its reinvestment policy regarding amounts received following the expiry of assets accumulated in its balance sheet. In effect, the Federal Reserve has continued to sterilise its balance sheet, purchasing new securities to maintain the total volume of its assets unchanged, replacing its agency debt, mortgage bond and public debt holdings. Such purchases have not affected financial markets in any significant way. Thus, in terms of mortgage bonds alone, the Fed has purchased an average volume of US$33.554 billion worth of securities per week.

This reinvestment policy will come to an end following the first increase in interest rates, as agreed by the Fed itself at its September 2014 meeting; as a result, Federal Reserve assets will gradually decrease as assets are not reinvested upon maturity. Nonetheless, the pace at which this occurs will be gradual, given the prudence applied by the Fed in its approach to normalisation. In this sense, it is not expected that the Fed will sell assets, and therefore, its balance sheet will only be reduced upon maturity of its securities. Thus, unless changes are made to this policy, Carpenter et al. (2013) believe that the Fed's balance sheet would not return to pre-2007 levels before 2020; however, bearing in mind that their assumptions have generally come to fruition later than expected, it is foreseeable that the balance sheet's return to pre-crisis levels may take even longer.

In the United Kingdom, the **Bank of England,** although not at quite an advanced stage as the Fed, is also embarking on a process of tightening its monetary policy, although the possibility of an increase in interest rates has dissipated over the course of the year. Like the Federal Reserve, the Bank of England has maintained historically low interest rates for a number of years (in the case of the UK, the reference rate has been 0.5% since March 2009); said rates have been accompanied by a significant volume of financial assets in the balance sheet. In effect, at the end of its asset acquisition programme in April 2013 for a total amount of £375 billion, the Bank of England has retained a constant stock of assets in its balance sheet, sterilizing assets upon their maturity.

It is expected that the Bank will continue this approach for the rest of the year, as confirmed at the Monetary Policy Committee meetings held on 6 August and 10

[6] Nye and Sly (2015), Coppola (2015).

September 2015, at which the decision was taken to retain the stock of assets by repurchasing an identical volume of assets to those maturing in September. Furthermore, at said meetings in August and September, following several committee meetings at which speculation was rife regarding upcoming rises in interest rates, only one of the nine committee members defended an immediate increase in rates based on the British macroeconomic climate. As a result, it is almost a certainty (when considered alongside the remarks made by Governor Carney in Jackson Hole) that rises will be left for 2016 (its forecast regarding average inflation for 2015 is 0.3% compared to 1.5% for 2016). Furthermore, as with the Fed, it is expected that increases in rates will be very gradual (the Monetary Policy Committee at the Bank of England itself has alluded to this in its recent meetings), lower than seen in previous growth cycles and implemented before reducing or eliminating the sterilisation of assets from the balance sheet. Aside from caution in terms of tightening monetary policy, other justifications include a fear of affecting budding economic growth and even further appreciation of the pound (since March 2013, the pound has increased by around 20% compared to other currencies, as stated by the Bank of England itself).

Elsewhere, the **Bank of Japan** is engaged in an ambitious asset purchase program. The use of these exceptional instruments is attributable to the infeasibility of applying traditional instruments (basically, reductions in interest rates, as rates have been at their lowest effective level for several years). Said programme, announced in April 2013 in order to duplicate Japan's monetary base between then and December 2014, was extended once the original end date came around (and once monetary expansion objectives were attained), given that the Japanese economy was failing to respond appropriately.

In effect, the monetary base has trebled (between April 2013 and September 2015), whereas the Japanese economy has still not reached a sustained rate of growth nor an increase in prices within the objective margins. Amongst the factors to which these measures failing to have an impact can be attributed, the greater-than-expected contractionary effect of the increase in indirect taxes approved in April 2014 has been significant. Given the imbalance between public finances and the high level of public debt, the Japanese government took the decision to increase VAT in two stages (the general rate from 5% to 8% in April 2014, with a further increase from 8% to 10% effective October 2015), which has a significant contractionary effect. In fact, following the contraction witnessed as a result of the increase in tax in April 2014, the government took the decision to postpone the increase initially set out for October 2015 by two years.

In light of these circumstances, the asset purchase programme has been extended and expanded for an indefinite period, as have the Bank of Japan credit facilities. Thus, the Bank of Japan continued to purchase ¥80 trillion per year (around €590 billion). In recent Bank of Japan meetings regarding monetary policy (in particular, the press releases issued on 7 August and 15 September 2015), this approach was repeated without any mention being made of the potential time horizon for these measures. As a result, markets do not believe an accommodative monetary policy will be applied until well into 2016.

In fact, in a working paper regarding the question of a member of the Governing Board of the Bank of Japan[7], reference was made to the need to maintain growth policies to restore the inflation target of around 2% in the medium and long term. Limited economic activity and inflation have contributed to said inflation expectations coming undone, despite the best efforts of the Bank of Japan.

3. MAIN MONETARY POLICY DECISIONS MADE BY THE ECB IN 2015: A TIMELINE

At the end of 2014, official interest rates set by the ECB were at their lowest effective level[8], with no clear results in terms of the attainment of monetary policy objectives. In fact, the aforementioned rates combined with the intention of keeping said rates low in the long term, budding private asset purchase programmes and the supply of liquidity to the banking sector, have failed to prevent the emergence of an evident risk of the 5-year inflation outlook coming undone in terms of the 2% target (negative inflation levels during a number of months in 2014 aside), in addition to significant discrepancies having been identified in conventional monetary policy transmission mechanisms. Thus, growth policies in place were not being reflected homogeneously throughout the European Union and the European Monetary Union. Furthermore, economic recovery in the eurozone was decidedly sluggish.

In light of the foregoing, experience in recent years recommended implementing two further lines of action to obtain similar results as those obtained by reducing interest rates: using forward guidance (in place at the end of 2014) on the evolution of intervention rates; and purchasing public or private assets in quantitative easing processes (although the ECB had already expanded its balance sheet by means of previous programmes, there was more room for manoeuvre here). In this sense, reference works such as Bernanke et al (2004) have served as a theoretical basis to implement these actions.

Important eurozone monetary policy decisions were taken at the start of 2015. A decision was taken at the Governing Council meeting held on 22 January 2015, after analysing the impacts of measures taken prior thereto and the price outlook, to implement an ambitious asset purchase programme including securitised assets, guaranteed bonds and government bonds.

This corroborates the inadequacy of all measures taken prior thereto, albeit implicitly; most measures focused on providing cheap funds to credit institutions so that they could provide support to the economy.

In fact, the early or scheduled repayment of the first LTROs was not to be offset by the new disbursements provided in the TLTROs; as a result, the ECB balance sheet began to shrink and it was expected that it would continue to do so in the following months. The foregoing, combined with low inflation (the HCPI in December 2014 fell

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[7] Shirai, Sayuri (2015).

[8] The official rate for the main refinancing operations ended 2014 at 0.05%, whilst the deposit facility was –0.2%.

by 0.2% YoY) and a limited inflation outlook for the following quarters (very gradual recovery was expected in the context of weakened growth) placed the ECB in an apparently inevitable position in which it would have to undertake a much more ambitious bond purchase than previously to reactivate the economy and underpin inflation expectations, as was the case in other economic areas a number of years prior.

With interest rates at historic lows and with no downward room for manoeuvre, the size of the balance sheet had become the main monetary policy tool of the issuing authority. In fact, at the end of 2014, Mario Draghi announced the ECB's intention to take its balance sheet close to the maximum levels seen at the start of 2012, at the peak of LTROs. Analyst calculations were clear: the expected evolution of the mechanisms rolled out or announced at the time would not make it possible, in any way, shape or form, to reach this goal. This is how the ECB's €1-billion objective came about.

As initially highlighted, and as we mentioned in the monetary policy chapter of last year's Yearbook, new measures were required to develop the Central Bank's balance sheet if it were to accomplish its objective of reaching this volume of assets: the use of covered bond or ABS purchase programmes was insufficient to cover expected growth. The debate focussed on limiting the type of assets to be acquired by the ECB in order to fulfil its goal of significantly increasing purchase volumes: whether by public sector assets only or by also acquiring corporate debt. As will be addressed later, the decision was taken to limit purchases to the public sector, by means of the PSPP, as it was understood that this approach would suffice in terms of volume, thus safeguarding some room for manoeuvre so that the programme could be extended to private sector assets, if necessary.

In reality **the expanded asset purchase programme announced comprised of three different programmes.** The first two had already been implemented; the new approach consisted of the purchase of government bonds.

The **first programme is the Covered Bonds Purchase Programme 3**. Following the purchase of these instruments in 2009-2010 (CBPP1[9]) and in 2011-2012 (CBPP2[10]), purchases under the new edition of the programme started on 20 October 2014, which will last for at least two years and form part of the measures that seek to have a significant impact on the ECB balance sheet.

The **second is the Asset-backed Securities Purchase Programme**, which started on 21 November 2014 and will also last at least two years.

The **third**, and most important both in terms of volume and asset type is the **Public Sector Purchase Programme**. Given the complexity involved, the purchase began on 9 March 2015.

Purchases for the entire range will amount to €60 billion per month; this figure will remain in place until September 2016 and until inflation reduces to targeted levels. This explicit and vast time horizon responds to the predictability required in terms of mone-

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[9] https://www.ecb.europa.eu/press/pr/date/2009/html/pr090604_1.en.html y https://www.ecb.europa.eu/press/pr/date/2010/html/pr100630.en.html

[10] https://www.ecb.europa.eu/press/pr/date/2011/html/pr111103_1.en.html

tary policy measures and, in some way, to the new approach to the forward guidance concept[11], applied since 2013 by the ECB Governing Council to send messages to the market regarding future operating guidelines regarding interest rates. At a time when no guidance was required concerning interest rate decisions, which have no downward room for manoeuvre and the time to increase them is not on the horizon, the message was sent that the purchase of assets is not a one-off policy, rather it represents a long-standing commitment with a significant impact in terms of volume (of more than one trillion euros, the benchmark figure mentioned above). Implicitly, support is being offered to economic growth, by underscoring demand and backing monetary and credit growth, as mentioned in the initial speech[12] by Mario Draghi at the press conference after the meeting.

At the same meeting on 22 January, other measures were also adopted to further relax monetary policy, in particular, it was announced that TLTRO interest rates would be reduced, eliminating the 10 basic point differential concerning the rate of the main financing operations applied to the first two TLTROs. The purpose of these measures was to make this type of financing a little more attractive to banks, who need to improve their credit extension policies to be granted access.

The following meetings of the governing council did not substantially affect the announcements made. On 5 March, following the meeting held in Nicosia, a number of technical aspects were published regarding the implementation of the programme to purchase public sector assets and its main characteristics were repeated (€60 billion per month in total, until at least September 2016). Draghi[13] started by highlighting the positive impacts of previous monetary policy decisions: ‘Financial market conditions and the cost of external finance for the private economy have eased further. [...] borrowing conditions for firms and households have improved considerably.’ 15 April [14], following the implementation of the PSPP, the message was very similar: the programme’s characteristics were highlighted and its effectiveness in terms of the real economy reinforced.

On 3 June[15] and 16 June[16], the message regarding asset purchase programmes continued in the same line as in previous meetings. After summer, during the meeting on 3 September[17], an announcement was made regarding a slight amendment to the ECB’s maximum purchase limit during a single issue (from 25% to 33%) and it was highlighted that the purchase programme is flexible and adaptable in terms of duration, composition and amount, where required by the circumstances. This demonstrates that the ECB is, as always, prepared to take action and if the corresponding circumstances occur, it has the flexibility to adapt the purchase programme to needs at the time.

However, during the final two meetings before summer, the focus of monetary policy had shifted from asset purchase programmes to the situation in Greece and, in par-

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[11] The ECB’s forward guidance, ECB (2014). *Monthly Bulletin*, April 2014, p. 65-73.
[12] Draghi, Mario (2015a).
[13] Draghi, Mario (2015b).
[14] Draghi, Mario (2015c).
[15] Draghi, Mario (2015d).
[16] Draghi, Mario (2015e).
[17] Draghi, Mario (2015f).

ticular, the use of emergency liquidity assistance, which was being used intensively by Greek banks. A mechanism that had initially been designed to respond to specific liquidity problems of solvent single banks experiencing one-off difficulties, which were unable to resort to standard ECB mechanisms to provide financing due to a lack of capital (which would resort to the national central bank, with a more relaxed collateral policy)[18] had become a form of life support to the Greek banking system. The Greek banking system, which the ECB deemed solvent based on its vital statistics, was facing a significant problem regarding lack of confidence, which could only be staved off temporarily by resorting to the ELA; however, this mechanism is not limitless or unconditional and so periodically, the ECB had to decide whether to increase the maximum limit The freezing of this limit at times of heightened tension during negotiations with Greece may have served as one of the main catalysts for an agreement having been reached. Following this agreement, the functionality of the ELA recovered somewhat, authorising the amounts requested by the Bank of Greece.

The other traditional monetary policy instruments continued working as normal. It is worth noting that despite the marginal deposit facility remaining negative, sums were not reduced significantly (what's more, there has been an upward trend since the start of 2015). This means that banks are still willing to deposit part of their funds, despite having to bear costs, given the availability and security offered by the instrument, before placing them on other financial circuits.

4. LTRO, TLTRO and ECB balance sheet

The ECB, having set official rates to their lowest effective level, faced several challenges. Once was the maturity of LTROs[19] between December 2014 and February 2015.

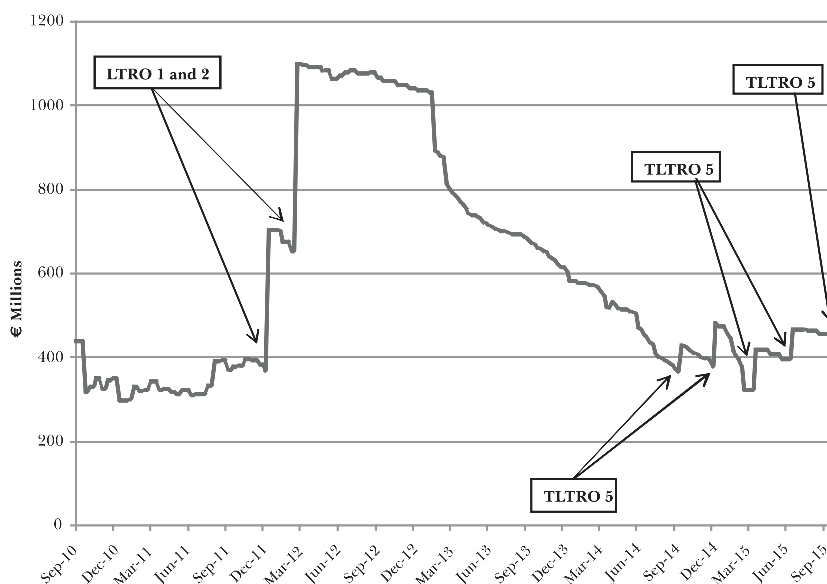
The difficulty faced by financial institutions overcoming said amortisations (initially, LTROs amounted to €1.019 trillion, although the amount pending amortisation upon maturity was notably lower than half the total amount, which was around □400 billion) combined with the fact that credit was still not flowing adequately (in fact, a large part of LTRO funds was set aside for the acquisition of government bonds). As a result, the maturity of these operations represented the perfect opportunity to reform the architecture of these measures. Thus, one of the first measures taken by the ECB in anticipation of this maturity (to overcome any liquidity tension that may be experienced by the financial system) was the expansion of the short-term, fixed rate, full allotment auction system undertaken in June 2014 through to at least the end of 2016.

[18] A good explanation of how the ELA works can be found in the 2013 edition of this publication: Fernandez, Fernando (2013). «Common monetary policy», *2013 Euro Yearbook*, pp. 147-149.

[19] *Long-term Refinancing Operations*, which refers to the 3-year loans granted by the ECB to financial institutions in December 2011 (for €489.190 billion) and February 2012 (for €529.530 billion) to offer them liquidity.

We can see (graph 4) that, although TLTRO operations are generating better-than-expected results when implemented, they are not providing additional financing to the banking system and are being used within financial institutions to obtain liquidity to finance themselves, without having to shift from the current limits of their loan portfolio, thus refinancing securities previously used for the purposes of financing, but at a better price. In fact, the amount loaned totals around €400 billion since summer 2014, without any significant increases expected in the short term given the conditions applied to these financing facilities (the amount loaned would need to be increased in order to preserve this instrument).

GRAPH 4. OUTSTANDING BALANCE OF THE ECB'S LONG-TERM REFINANCING OPERATIONS



Source: European Central Bank.

At the end of 2014, it became evident that the measures announced were not providing the markets with the sensation that they were contributing to the recovery nor that they could guarantee the anchoring of inflation expectations. Therefore, in September 2014 the ECB approved two private debt purchase programmes (CBPP3[20] and ABSPP[21]), with the objective of providing guaranteed bond markets with liquidity (with

[20] *Third Covered Bond Purchase Programme.*
[21] *Asset-backed Securities Purchase Programme.*

covered bonds worth particular mention) and securitisation markets. Considering that the measures (CBPP3 and ABSPP programmes) could entail between €370 billion and €560 billion depending on the estimates used, by the end of 2014 it was clear that the ECB had prepared another measure to expand its balance sheet in terms of the pledged volumes.

5. EUROPEAN QUANTITATIVE EASING: ANALYSIS OF THE INSTRUMENTS

As mentioned above, the ECB's expanded asset purchase programme comprises three programmes: two of which were implemented in 2014, whilst the third represents the new approach inaugurated in 2015.

Having demonstrated the inadequacy of the monetary policy **banking approach**, at the start of 2015, the Central Bank took the decision to shift the discourse and the instruments used to further relax monetary conditions in an environment in which rates were already at their lower limit.

By monetary policy banking approach, we mean the direction of unconventional measures prior to January 2015. Despite the vast funds provided by the ECB, credit remained weak and institutions used these funds to protect themselves against possible future hardship and keep their books in order.

Therefore, although the ECB has assets from two purchase programmes (ABSPP and CBPP3), it understands that if it wishes to generate significant purchases, it needs to expand upon its acquirable assets. This represents the precise moment at which the approach shifts from the banking perspective to the **direct approach.**

Calls had been made for the ECB to implement such a change for some time, as it was believed a quantitative easing programme similar to the one implemented in the US was needed in Europe. Furthermore, the anchoring of inflation expectations, which is the ECB's main mandate, was not generated, as can be seen by the fact that in the final months of 2014, listed financial instruments linked to expected inflation were at historically low levels.

The justification for this change of approach can be found in the ECB's Economic Bulletin[22], in which the monetary authority declares that it is satisfied in terms of the transmission of liquidity of unconventional measures announced at the time of publication to the private sector in terms of cost reduction (interests), but not to such an extent in terms of amounts.

In an article[23] economists at the ECB addressed the goals pursued by central banks when expanding their balance sheet: provisioning of liquidity, improving the transmission of monetary policy, supporting the provision of credit to the real economy, improving the financing conditions of stakeholders, stimulating the creation of new credit, driv-

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[22] ECB (2015a). *Economic Bulletin*, 1/2015, pp.15-18.

[23] ECB (2015b). 'The Role of the central bank balance sheet in monetary policy'. *Economic Bulletin*, 4/2015, pp.61-77

ing growth and, ultimately, redirecting the path of inflation. These are the basic objectives pursued by the ECB by means of these measures.

Thus, the ECB estimates that with rates at their lower limit, expanding and changing the composition of its balance sheet is the **only effective tool** at its disposal to make monetary policy even more accommodative. Thus, it steadfastly complied with its aim of using all mechanisms within its reach for a period of less than two years and, in any case, until inflation expectations are redirected. Its intention was to improve confidence and support inflation expectations, whist reducing the profitability of public debt. This drop in profitability would affect prices due to the reduction in the profitability of other assets, in particular, loans to the real economy, and volumes by promoting the transfer of part of the funds currently deposited in public debt towards other types of assets, thus significantly relaxing monetary conditions with a general impact on private sector financing.

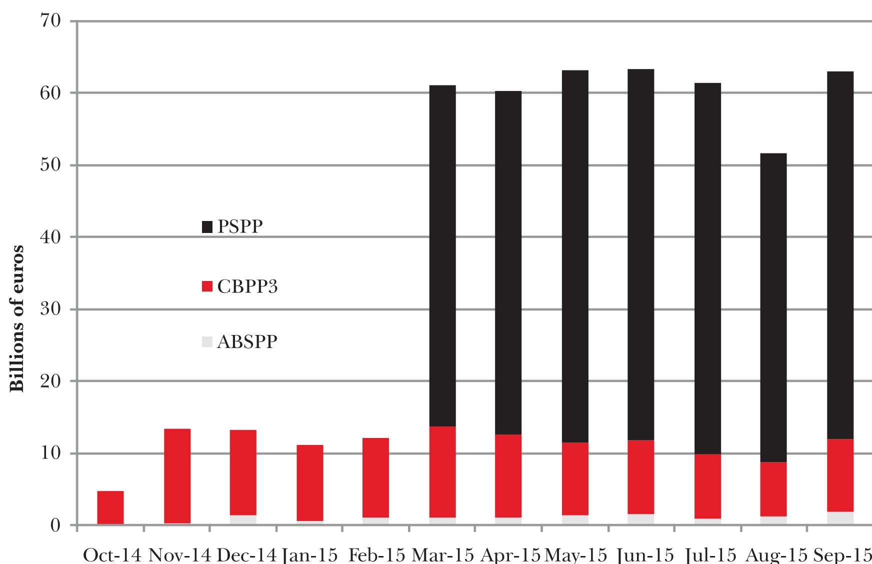
As highlighted by the Bank of Spain in its 2014 Annual Report[24], transferring ECB policies to attain the inflation target can be obtained in three ways, which we highlight and discuss below:

a. *The price of assets.* Purchasing such volumes of securities exerts obvious pressure on the prices that the market is willing to pay for said assets.
b. *Restructuring of portfolios (replacement).* The lower profitability of public debt assets adversely affects the attractiveness of securities for investors; logically, they would seek other positions which offer a higher return.
   Another channel linked to this restructuring of portfolios (also influenced by the architecture of new LTRO auctions) would be to make carry trade[25] less attractive to European banking, making it possible to trigger the granting of new credit to companies and families once again (which is without a doubt one of the objectives of the ECB).
c. *Expectations.* In effect, ECB policy represents a clear indication of what is to come over a relatively long period of time so that economic stakeholders can adjust their expectations from the offset.

The expanded asset purchase programme comprises three different instruments. Its objective is to play a significant role in the market with **monthly purchases of around €60 billion** up until at least September 2016, or until the Governing Council establishes that inflation has been brought close to target levels.

[24] Banco de España (2015): 'La política monetaria', *2014 Yearly Report,* pp 43-66, Banco de España, Madrid, June 2015.
[25] Use of money borrowed at low interest rates from the European Central Bank to invest in the purchase of public debt securities.

GRAPH 5. EXPANDED PURCHASE PROGRAMME: MONTHLY PURCHASES PER PROGRAMME



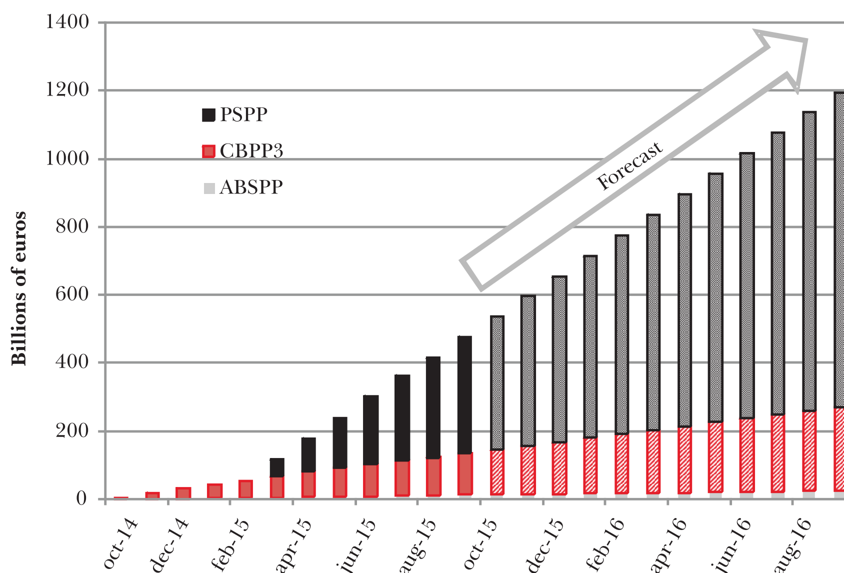
Source: ECB.

As can be seen in graph 5[26], the quantitative weight of the purchase programme rests with public sector stocks, which account for 80% of purchases from March, when operations began. The guaranteed bond programme represents around 18%, whilst securitisation bonds represent around 2% of monthly purchases.

Nonetheless, the ECB seeks to expand its balance sheet significantly and is resolute in its intention to do so by focusing on the purchase of public sector securities. At this rate, the total volume injected by the Eurosystem in the real economy via the three aforementioned programmes would exceed one trillion euros in summer 2016 (graph 6); under such circumstances, ECB assets would be close to the established target of recording levels seen in 2012.

[26] Updated data regarding the evolution of different purchase programmes can be consulted at: https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html

GRAPH 6. EXPANDED PURCHASE PROGRAMME: ACCUMULATED STOCK AND FORECAST



Source: ECB.

Below are the main characteristics of each programme:

5.1. *ASSET SECURITISATION BOND PURCHASE PROGRAMME*

Programme name	**Asset-backed securities purchase programme (ABSPP)**
Asset type	Guaranteed bank bonds
Start of purchasing	October 2014
Market	Primary and secondary (primarily)
Volume acquired	13,015 (September 15)
End of programme	At least until September 2016

The programme focuses on purchases from senior tranches and guaranteed mezzanine tranches on primary and secondary markets.

As regards the former, they must be accepted as a guarantee in Eurosystem credit operations, be denominated in euros and have been issued by residents of the euro area. Supporting assets must be credits held with non-financial private sector entities residing in the eurozone (with a minimum of 95% denominated in euros and a minimum of 95% residing in the eurozone).

The second best rating must be at least level 3, or BBB-/Baa3/BBBI (although an exception has been established for Greece and Cyprus: if other additional requirements are met, purchases may be made). The maximum that can be purchased from each issue is 70% (determined by the corresponding ISIN code).

5.2. *COVERED BONDS PURCHASE PROGRAMME*

Programme name	**Covered bond purchase programme 3(CBPP3).**
Asset type	Simple asset-backed securities
Start of purchasing	December 2014
Market	Primary and secondary (mainly)
Volume acquired	121.151 (Sep-15)
End of programme	At least until September 2016

Covered bonds in euros will be purchased gradually in the primary and secondary markets. The eligibility criteria are based on acceptance conditions in monetary policy operations. They must also be issued in euros by eurozone entities and have a minimum level 3 credit rating (equivalent to BBB-). Specific criteria were set for Greece and Cyprus, as it was impossible for them to comply with the required rating.

There is also a limit of 70% of each issue (per ISIN code), or 30% for Greece and Cyprus. Totally retained issuances are also explicitly accepted.

The goal of this programme is to help the transmission of monetary policy by influencing the prices of this specific instrument, covered bonds. The rationale behind it is that an increase in the price of these bonds, due to the strong link between the instrument and the loans which guarantee it, should provide a greater incentive to grant new loans and thus have more options for creating covered bonds. The goal is to encourage new credit, while reducing the yield of these bonds, which should be transferred to other assets, which will also have their profitability reduced as new investors enter for whom the covered bonds are not enough.

5.3. *PUBLIC SECTOR PURCHASE PROGRAMME*

Programme name	**Public sector purchase programme (PSPP)**
Asset type	Public marketable debt instruments issued by European states, agencies and institutions
Start of purchasing	March 2015
Market	Secondary Market
Volume acquired	€341.462 billion (Sep-15)
End of programme	At least until September 2016

The purchase of public sector marketable debt instruments represents a real change of approach in the unconventional measures adopted by the ECB. The two previous programmes were intended to complement and improve the effectiveness of long-term refinancing operations (LTRO, TLTRO).

This step forward means intervening in European sovereign debt markets, injecting liquidity directly into the system without the banking channel acting as an intermediary. However, it is true that these funds are not allocated directly to households and businesses, but to the public sector, and therefore their influence on the former is still indirect. Thus, direct intervention in corporate debt still remains as a new measure which could be adopted by the ECB if it believes the current measures are not effective enough.

The purchase of these instruments is intended to enable their holders to use the amounts obtained to acquire other assets and grant loans in the real economy. The purchases will obviously not be sterilised, so there will be a net injection of funds into the system by the ECB.

The programme is designed as follows: it will acquire debt instruments issued by central governments in the eurozone, some agencies in member states, and some international or supranational institutions. It will be **distributed by countries according to the ECB's capital key,** i.e., proportional to each state's participation in the capital of the Central Bank. The purchases will be made by the ECB itself on one hand, and the National Central Banks on the other, and always supervised and directed by the ECB to ensure the uniform application of monetary policy.

It is important that these purchases reflect the pattern of participation by the countries in the ECB's capital, as this differentiates this purchase programme from others, used or not, which attempted to mitigate the specific problems of certain sovereign issuers. We refer to the *Securities Market Programme* and the *Outright Monetary Transactions* programme, where the purchases or announcements were intended to disincentivise aggressive positions against sovereign debt by some investors in certain countries. Now the intention is to boost the real economy of the eurozone as a whole, hence the neutral criteria for distribution among countries.

A set of technical conditions[27] for the admissibility of the marketable instruments, including a residual maturity of two to 30 years, being eligible according to the Eurosystem's criteria for monetary policy operation, and having a minimum category 3 credit rating (although there are exceptions for countries in assistance programmes).

To ensure purchases are **neutral**, they will be made at market prices in order not to distort market pricing. To this end, the Eurosystem accepts the same treatment as all other creditors (*pari passu*). It also sets maximum purchase limits, at 33% of the outstanding balance of eligible issuances by a single issuer, and 25% of each issuance (extended to 33% of each issuance at the meeting of 3 September). The intention is to avoid the position of the ECB in relation to a given issuance being significant if collective action clauses could come into play, and it also includes purchases in the context of

[27] For the technical criteria, see https://www.ecb.europa.eu/press/pr/date/2015/ html/pr150122_1.en.html and https://www.ecb.europa.eu/mopo/implement/omt/html/pspp.en.html

other programmes (in particular, in the *Securities Markets Programme*). The limit of 33% per issuer is intended to safeguard the correct functioning of the markets, preventing the ECB from being the dominant creditor of any issuer.

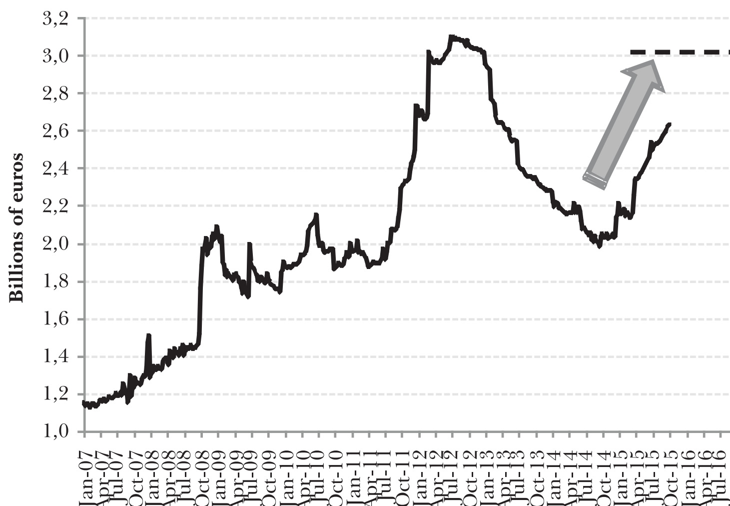
An element which was regarded as very important when discussions on purchasing instruments began is the **risk sharing** scheme. The first thing to note is the non-privileged nature of the ECB as a creditor (*pari passu*). The other important aspect relating to the assumption of possible losses is the loss mutualisation system. The design of the system means that the purchasing entity assumes the risk, i.e., the National Central Banks and the ECB. As most of the debt of a given country is acquired by its own central bank, mutualisation is minor. It only occurs for 8% of the total to be acquired by the ECB, more for the 12% referring to supranational entities, where risk is fully shared, regardless of the purchasing Central Bank.

The pace of purchasing in the PSPP programme is around 50 billion a month, which with the other two programmes would reach the announced 60 billion. Therefore, as expected, most of the volume of the expanded asset purchase programme centres on government securities.

In short, the expanded asset purchase programme is being implemented successfully so far, and has progressed as expected, with announced purchases based above all on the public sector purchasing programme.

TABLE 1. IN SEARCH OF A TRILLION EUROS

GRAPH 7. TOTAL ASSETS OF THE ECB



Source: ECB.

On 22 September 2014 Mario Draghi surprised the world with an important (and unexpected) statement that the ECB intended to increase their balance sheet «towards the dimensions it used to have at the beginning of 2012», in the context of his speech at the European Parliament's Economic and Monetary Affairs Committee[28]. Analysts soon decided that announcing such a large increase in the balance was a very important milestone in monetary policy.

Indeed, this was an ambitious goal, as at the time the balance sheet was around two trillion euros and in early 2012 it was around three trillion, so the difference was the considerable sum of one trillion euros.

Although at the beginning there were doubts as to the effectiveness of this commitment, it was soon confirmed, as could be expected, that this was an explicit policy of the Governing Council. Specifically, the opening speech of the press conference of 6 November[29] stated that the current programmes were expected to have a considerable impact on the ECB's balance sheet, which would bring it back to the levels of early 2012. To dispel any doubts, during the Q&A Draghi confirmed that this was the ECB's intention, and did not dismiss the figure of a trillion euros that analysts were already discussing.

[28] https://www.ecb.europa.eu/press/key/date/2014/html/sp141117_2.en.html
[29] Draghi, Mario (2014 b).

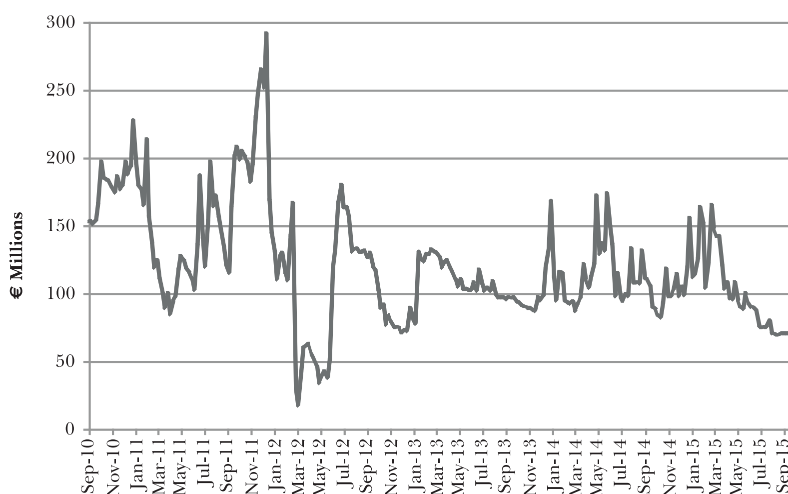
6. OTHER INSTRUMENTS: INTEREST RATES, THREE-MONTH REFINANCING OPERATIONS, LENDING AND DEPOSIT FACILITIES, ELA

In 2015 the ECB's monetary policy was dominated by the announcement and launch of this expanded asset purchase programme. However, the other instruments available to the Central Bank have been used as normal. Below, we discuss the progress of each one over the last year.

First, in interest rates, there were no changes to the reference rates, which since September 2014 had been 0.05% for main refinancing operations, 0.30% for marginal lending facilities, and -0.20% for marginal deposit facilities.

In the main refinancing operations (Graph 8), the ECB's outstanding balance with eurozone entities began to fall in March, with the full implementation of the expanded asset purchasing programme.

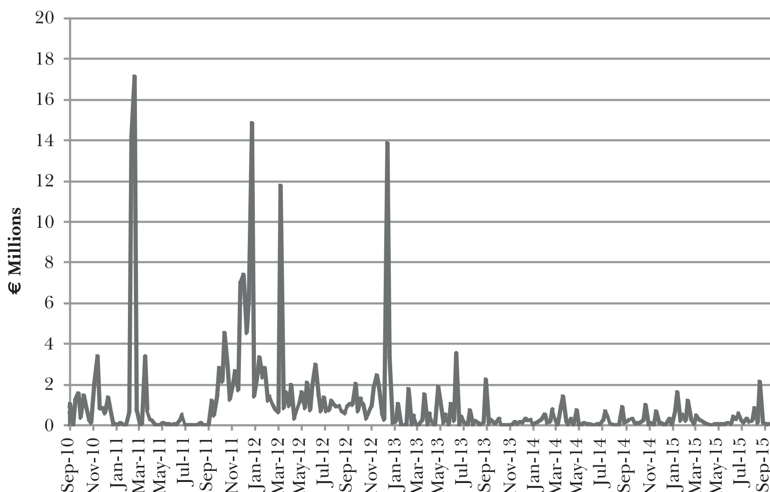
GRAPH 8. ECB: MAIN REFINANCING OPERATIONS. OUTSTANDING BALANCE



Source: ECB.

The **lending facility**, by which the ECB makes last resort loans to entities with one-off needs which cannot be met by other instruments, has remained at trace levels (Graph 9), with occasional requests at specific moments for amounts with no significant effect on the balance sheet of the Central Bank.

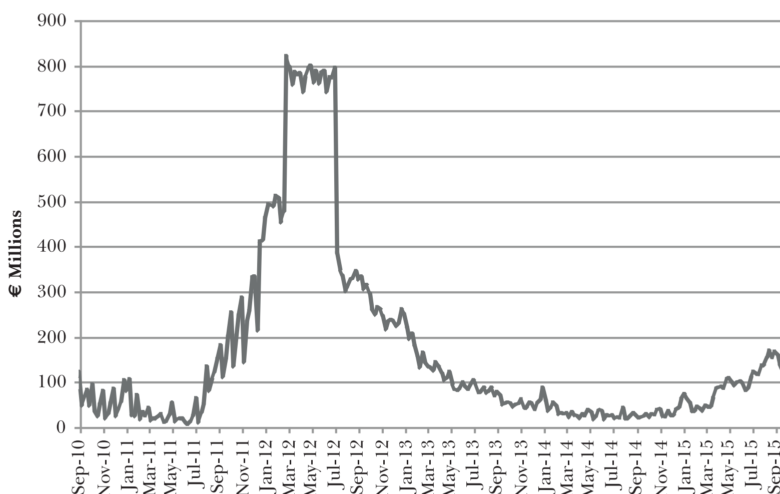
GRAPH 9. ECB: MARGINAL LENDING FACILITY. OUTSTANDING BALANCE



Source: ECB.

Finally, the **deposit facility**, in which the entities with excess liquidity can deposit their funds, paying for this service (the interest rate is negative), has been increasing steadily since the start of the year (Graph 10). While financial normalisation and the recovery of confidence meant that entities used this facility, and despite offering negative yield (0.20% since September 2014) it continues to attract a reasonable amount of funds.

GRAPH 10. ECB: DEPOSIT FACILITY. OUTSTANDING BALANCE



Source: ECB.

What has become unusually important this year is **emergency liquidity assistance**, which the ECB provides for banks with occasional liquidity problems (ELA). The general procedure[30] for providing this assistance establishes that national central banks can make funds available to solvent entities for dealing with occasional liquidity problems. It should first be noted that this is an exceptional instrument, beyond the typical monetary policy operations that in principle could also be used for banks in difficulties. For cases where these cannot be used, due to insufficient collateral or another reason, this special instrument can be activated.

The **costs and risks** of these operations are assumed by the corresponding national central bank, without any existing Eurosystem scheme for mutualising debts.

All of this makes ELA an instrument to safeguard financial stability in the eurozone, but not a true monetary policy instrument. It is true that financial stability is a necessary requirement for the correct application of monetary policy and its transmission to all the eurozone economies, but as stated, it is not strictly a monetary policy instrument.

In all cases there is the possibility of the ECB limiting ELA operations if it judges them to interfere in the goals and tasks of the Eurosystem. Two thresholds are established at 500 million and 2 billion euros, from which the ECB's supervision and reporting is more intensive (a ceiling can also be set).

This mechanism is designed to help specific entities to face temporary problems. The entity must be solvent and its problem must be limited to liquidity. Thus, in the past, the respective central banks assisted various Irish entities, Hypo Real Estate in Germany, Dexia in Belgium, and Greek and Cypriot banks. But there is a great difference between cases: in some, an entity with problems was supported, without a generalised problem in the country's banking system. This means these operations are not totally transparent, to avoid the entity in difficulties being even more disadvantaged by a lack of confidence. But in other cases, as was again demonstrated in 2015, the specific problems of the entities concealed general problems in the banking systems of the country in question. Assuming that in all cases the banks met the solvency requirements, the fact that these were not isolated cases but affected the whole sector changes the scenario considerably.

And this is what happened again in 2015 with the Greek banks: banks which were solvent in theory, but with serious liquidity problems due to the flight of deposits caused by a lack of confidence. All of this was happening while the Greek government was negotiating with the European and international institutions to renegotiate the conditions of their bailout. Thus what was a technical instrument for supporting specific entities as needed became an iron lung for a whole banking system. Therefore, decisions on increasing, freezing or removing it was no longer a technical adjustment, but formed part of Greece's complex negotiations with Europe.

[30] For more details see https://www.ecb.europa.eu/pub/pdf/other/201402_elaproce- dures.es.pdf?c18f465f3fb9839fa55429d26fe26463

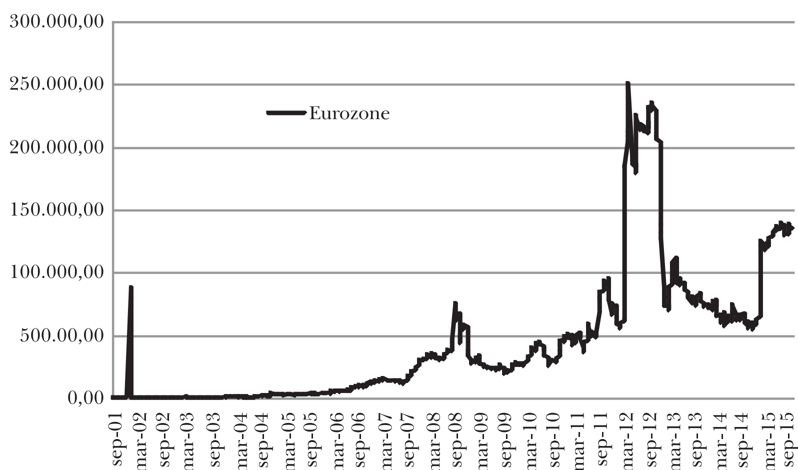
Without getting into too much detail on the negotiations of the third Greek bailout, **ELA** became one of the **main elements** in the **negotiations**, as the Greek government was aware that without this emergency liquidity its banks would be in an unsustainable situation, so that its freezing or elimination could spell their exit from the euro.

This renewed systemic importance of ELA led Draghi to recognise that there would need to be a new approach to the decision-making and communication procedures for this instrument. As mentioned, the risk is assumed by the corresponding national central bank, which would be liable for any losses.

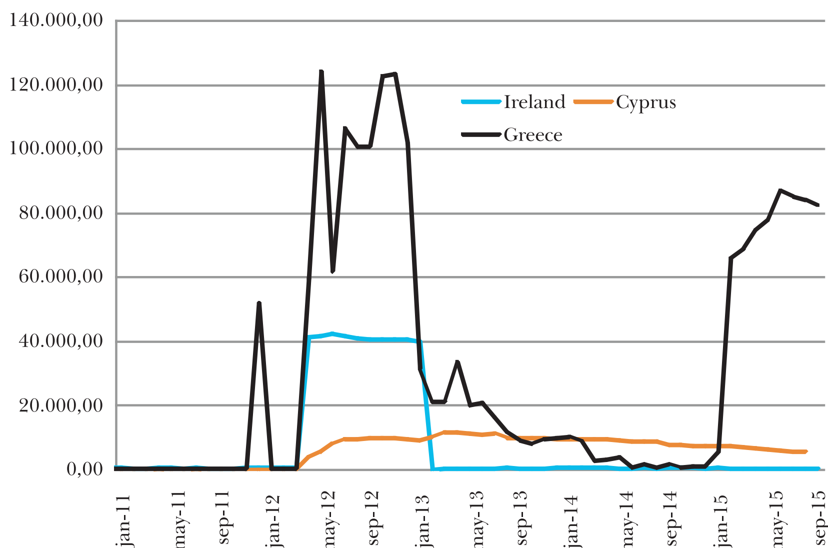
However, belonging to the Eurosystem requires taking due care to safeguard financial stability, as problems in the balance sheet of a national central bank in a state with serious problems in its public finances could have a knock-on effect on the rest of the Eurosystem.

To analyse the use of this instrument, we find ourselves with a double difficulty: on one hand the ECB does not publish the amounts issued in this way, and we have to look at its balance sheet, under the heading «*Other claims on Euro Area credit institutions*». Also, the amount is not broken down by country, so we have to go the national central banks to find the participation of each one in this heading. This relatively opaque communication policy is because, as mentioned above, the primordial purpose of this assistance is to help specific entities with occasional problems, so that some caution is required in communicating the operations. As can be seen in Graph 11, during this crisis, there have been episodes in which one or other entity in some countries has used this mechanism, contrasting with the massive use by countries with systemic problems in their banking systems, which finally led to bailouts (Graph 12).

GRAPH 11. OTHER CLAIMS ON EURO AREA CREDIT INSTITUTIONS (TOTAL)



GRAPH 12. OTHER CLAIMS ON EURO AREA CREDIT INSTITUTIONS (SELECTED COUNTRIES)



Source: Datastream.

As described above, the Greek banking system has had to resort to ELA on several occasions. The massive flight of deposits caused by uncertainty about its public finances and the need for outside help led to very substantial liquidity needs (Graph 13) in its banks, as shown in Table 2.

TABLE 2. GREECE, DEPOSITS AND ELA

Although it is not the only deciding factor in the management of a credit entity's liquidity, it is true that larger than usual deposit withdrawals can trigger a liquidity crisis which would be hard to weather without outside help.

Severe lack of lack of confidence about the Greek banking system, as a consequence of its sovereign financial problems and their knock-on effect on the Greek financial and real economy led to a gradual flight of deposits from Greek banks to other places in search of greater security.

The guarantee offered to depositors of 100,000 euros per holder and deposit is not supported by sufficient funds (as in the other countries) but is rather based on confidence that the national authorities, if push comes to shove, will honour this commitment.

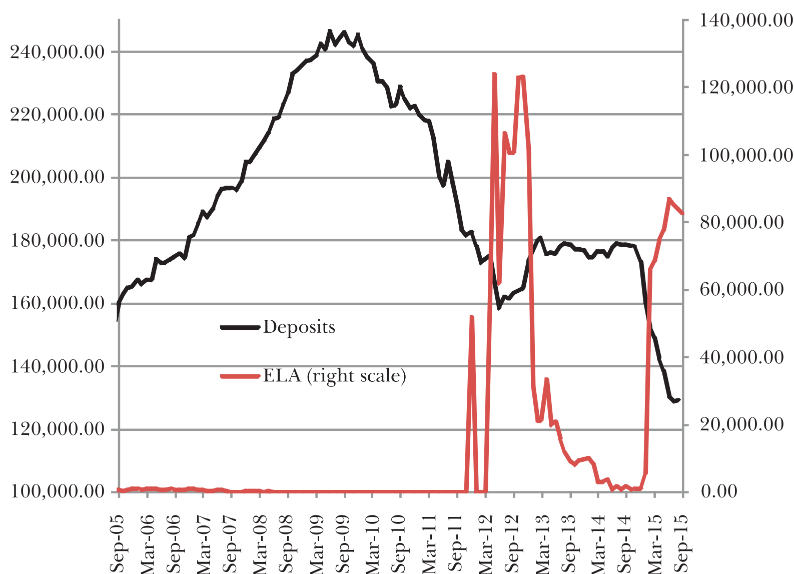
As Greek public finance is in such a delicate situation, it is probable that any increase in uncertainty would lead to greater withdrawals of deposits than in normal circumstances.

Despite the imposition of capital controls and the limitations on cash withdrawals decreed in the most delicate moments of the 2015 negotiations, the flight of deposits could not be stopped.

Also, the withdrawal of deposits was much more intense in non-financial companies than among individuals: with data up to July, deposits fell by nearly 40% compared to their level in July 2015, while among households the figure for the same period was 23.8%. Perhaps the companies have more instruments for moving their deposits to more secure places.

The impact of deposit behaviour on the need for ELA is clear: while the fall continues, banks can cope with their liquidity needs until the rate of withdrawals speeds up and the situation becomes unsustainable, at which point the ECB's emergency liquidity is required.

GRAPH 13. GREECE: BANK DEPOSITS AND ELA



Source: Datastream.

7. CONCLUSION: THE EFFECTS OF THE MEASURES.

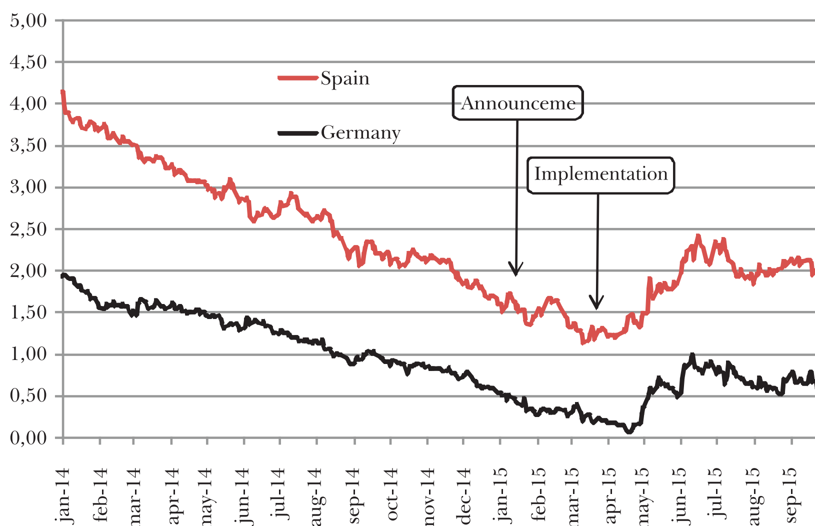
Below, we analyse the effects of the ECB's 2015 programmes. The first element to consider is the difficulty of **isolating the effect of the ECB's policies from the rest of the economic and financial context.** In particular, two new phenomena over the year affected the transmission of monetary policies: the **fall in oil prices** and the weakening **prospects for world growth after the summer** (China), increasing volatility and leading to a repricing of most of the world's financial assets.

The ECB's mandate is concerned exclusively with **inflation**, so that all its current measures are ultimately intended to drive inflation rates and expectations to the target level of 2%. However, the decisions are transmitted via several channels.

In general, the effects of the extraordinary measures, and in particular, the expanded purchase programme, can be divided into three blocks: **effects on asset prices, substitution effects and effects on expectations.**

In effects on **asset prices**, the first transmission channel was obviously **public debt yields**, which is one of the variables which should be most directly affected by a programme like this one, as a major new purchaser increases the demand for this asset and this raises its price, lowering yields. Here we must distinguish between the time of the announcement, when yields start to fall, and implementation, when the fall has almost stopped and will begin rising over the following weeks.

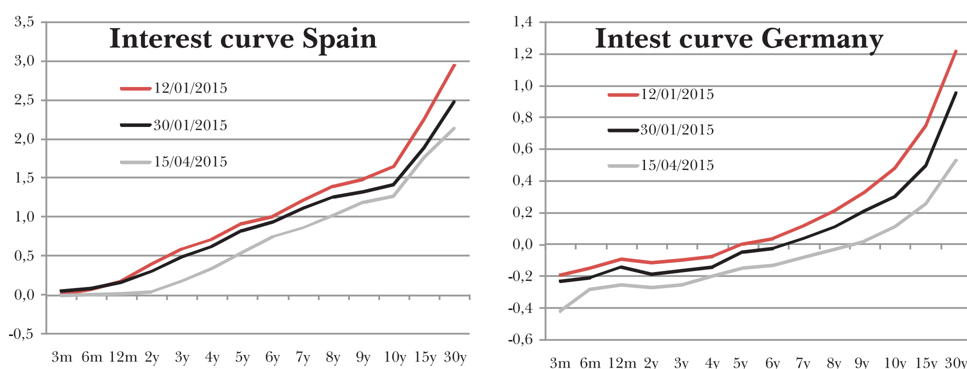
GRAPH 14. 10-YEAR BOND YIELDS



Source: Datastream.

The effect was not the same at all points on the debt curve (Graph 15), as the fall was more pronounced in periods of three to five years, where a priori the ECB's purchases act more directly. In fact, after the announcement, the fall in yields meant that much of the paper in circulation was quoted at negative rates, in what was interpreted as the «new normal». But this normality did not last long, and the percentage of bonds traded below zero was significantly reduced after the repricing which began in May, due to the uncertainty about the world economy which arose at that point.

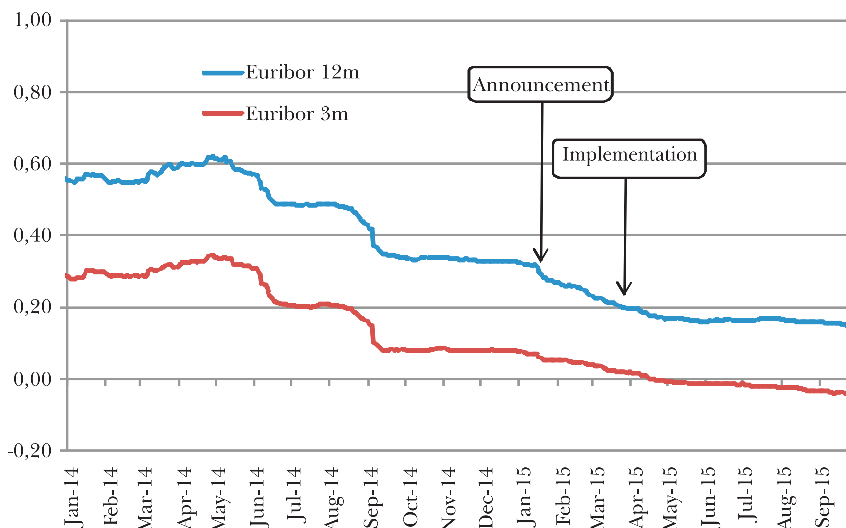
GRAPH 15. YIELD CURVE BEFORE AND AFTER THE ANNOUNCEMENT AND IMPLEMENTATION. SPAIN AND GERMANY



In **short term interest rates** the announcement caused another fall, even though levels were already very low, and this fall has continued, although more moderately, with the actual purchases (Graph 16). The announced duration of the programme until at least September 2016 compressed monetary rates, and it appears it will keep them depressed for a long time, as the expected time to leave the ECB's current monetary policy is still a long way off.

As for the **effectiveness of the other two current programmes** (CBPP3 and ABSPP), they have also been seen to compress yields in the instruments they act upon. As Praet says (2015 a), in the first months of the programme a marked contraction was already being seen in the spreads of the covered bonds, which reached their narrowest levels in the last five years. The ABS also began with a general compression of differentials, although in some jurisdictions this reduction would disappear later. In fact, the repricing process mentioned above cancelled out much of the improvement, although the programmes could not be said to be ineffective, as if they were not in place, the effect on increasing yields could have been even greater.

GRAPH 16. MONEY MARKET



Source: Datastream.

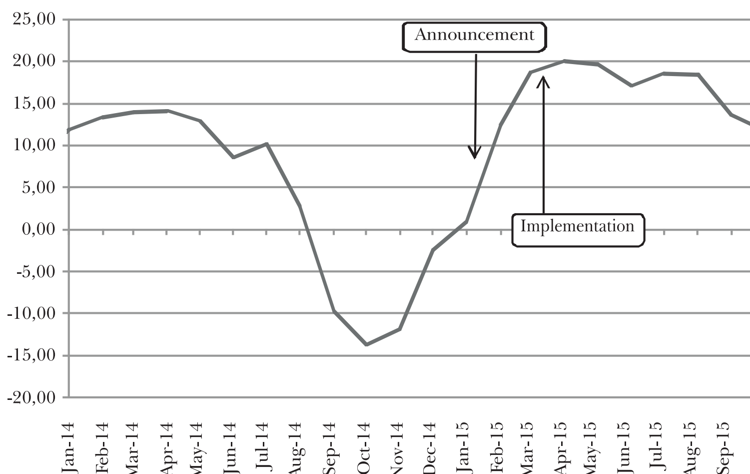
Other types of effects relate to the **substitution effect**. The entrance of such a large purchaser in the markets where the programmes operate led to the exclusion of some other investors, due to not having the desired yield. These investors switched to buying corporate bonds or other higher risk assets (including the stock exchange), increasing their prices. There may also be a certain reduction in the carry trade alongside an increase in the loans issued by European banks (see Graph 18b on new loans to companies).

The third group of effects is on **expectations.** The SENTIX indicator of **investor** confidence in the eurozone (Graph 17) shows how the announcement of the measures meant a strong boost to investor confidence, and these levels were maintained after implementation when they would probably have fallen further due to turbulence in China and other emerging markets.

The combination of all these effects, which we could call first round effects, should lead to another series of consequences, which we can call **second round** effects, which would relate to credit issued to the real economy and its transmission to growth and inflation.

First, we can state that the most immediate consequence of lower public debt yields is transferred to states in the form of **lower financial costs**, making their fiscal position easier.

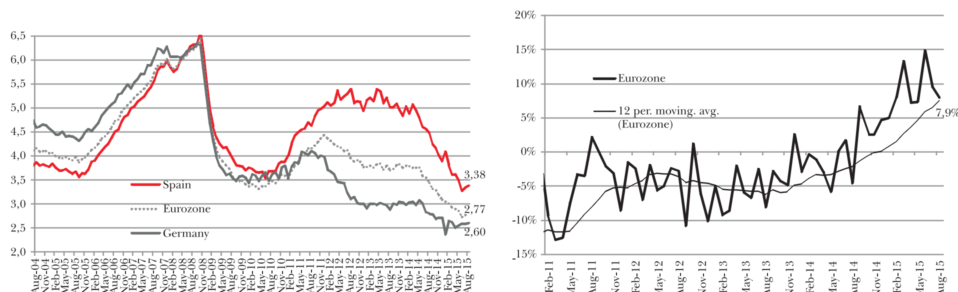
GRAPH 17. SENTIX INDICATOR: INVESTOR CONFIDENCE



Source: Thomson Reuters Datastream.

To observe success in the transmission of monetary policy we can look at the behaviour of **interest rates and volumes of new loans to companies** of less than a million euros (Graph 18). In the aggregate eurozone and in the case of Spain, we can clearly see a sustained reduction of the rates demanded since the spring of 2014. Although the **amounts** trended upwards for the eurozone as a whole throughout 2014, this was accelerated in 2015 by the announcement and launch of the programmes.

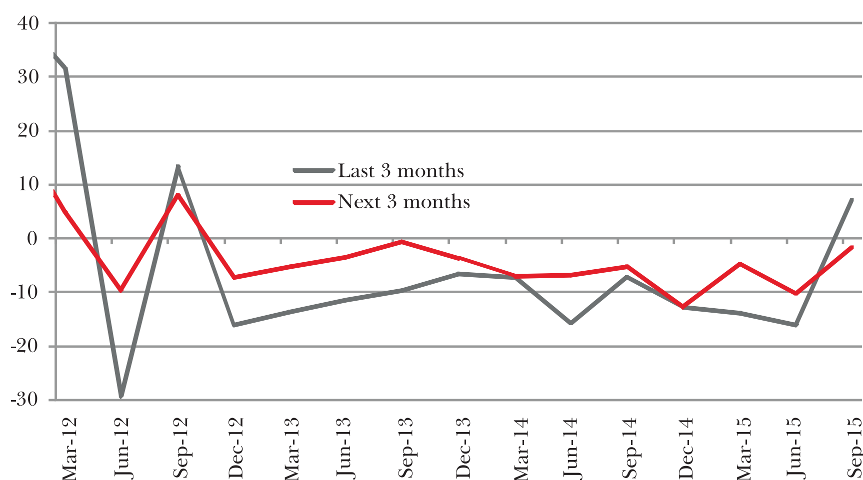
GRAPH 18. VOLUME OF NEW COMPANY LOANS UP TO ONE MILLION EUROS (IA VARIATION RATE)



Source: ECB. *Fuente: BCE.*

The **Bank lending survey**31 conducted each quarter by the ECB in collaboration with the national central banks also shows a greater willingness among banks to lend to their clients from the first quarter of 2015, although moderate. This survey also asked questions about the consequences of the situation of the financial markets for certain variables relevant to banks. These include the improvement experienced by eurozone entities in sources of financing via **medium and long-term issuances** (although this improvement was interrupted by the well-known repricing process discussed above).

GRAPH 19. BANK LENDING SURVEY: EUROZONE. CHANGES IN ACCESS TO FINANCING VIA MID TO LONG TERM ISSUANCES



Dissemination indicator: Percentage of entities that have toughened their criteria considerably x 1 + percentage of entities that have relaxed their criteria somewhat x 1/2 percentage of entities that have relaxed their criteria considerably x 1.

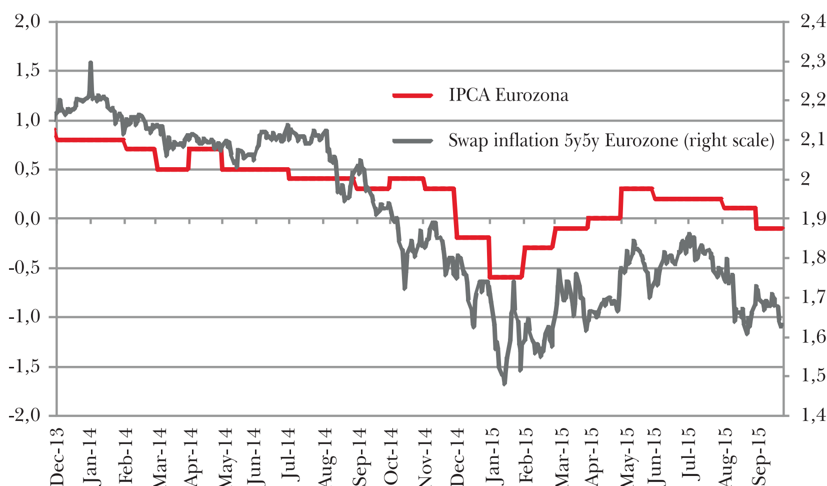
Source: ECB.

In the same survey, the ECB has begun asking questions about the **effects of the expanded asset purchasing programme** on certain variables. There is still only one observation, but it can already be seen how, in net terms, the entities show that they have relaxed their conditions for granting loans and the terms and conditions of the granted loans, especially in financing or companies, thanks to this new step in monetary policy.

[31] It can be consulted at: https://www.ecb.europa.eu/stats/money/surveys/lend/html/index.en.html

In terms of the impact of all these effects on **inflation,** the ultimate objective of all the measures, we begin with the situation in the last months of 2014, when there had been a sharp fall in inflation measured in year-on-year growth of the IPCA, taking it into negative figures in December (Graph 20). At the same time, expectations measured via the 5y5y inflation swap rate of the eurozone had also fallen to around 1.6%, not at the 2% the ECB wanted to approach. The announcement and later launch of the expanded programme, beginning in January 2015, drove expectations of inflation, although after then a moderate trend began, caused by lower expectations of European and worldwide growth.

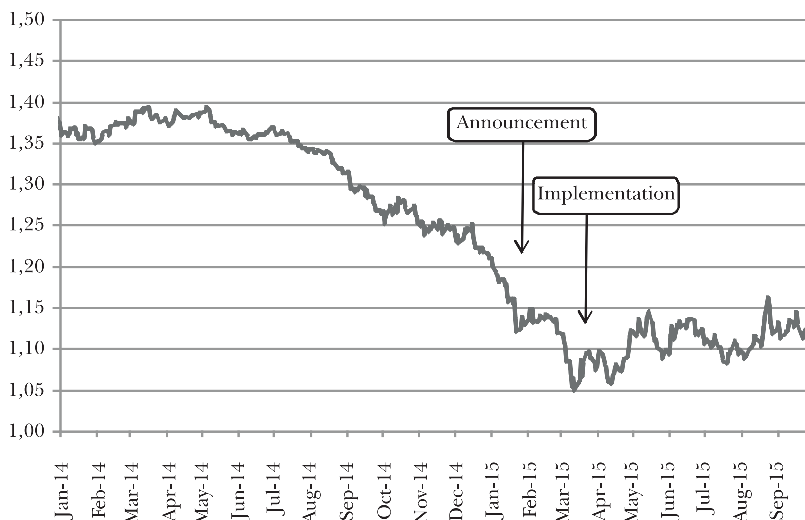
GRAPH 20. EUROZONE: INFLATION AND EXPECTATIONS OF INFLATION



Source: Eurostat and Bloomberg.

Finally, although not one of the variables used by the ECB to measure reactions to its monetary policy decisions, the **exchange rate** is one of the indicators that can be most affected by these decisions. Although there are obviously many more factors affecting currency trading, the announcement by Mario Draghi in January 2015 that a major asset purchasing programme was going to begin led to the euro falling against the dollar (Graph 21), due to the expectation of an even greater relaxation of monetary conditions in the eurozone, in contrast to the prospect of the USA's exit from their current strategy at the time.

GRAPH 21. DOLLAR-EURO EXCHANGE RATE



Source: Datastream.

Evidently, the consequences of expansive monetary policies also have effects at the global level. The evidence is that **monetary laxity in advanced economies** has contributed to sustaining greater **growth in emerging economies**, especially via the commercial channel and the maintenance of favourable financial conditions (IMF, 2013).

In fact, for most variables we can see that the agents had already anticipated this measure and financial conditions had already begun to improve, even before the launch of the public sector purchase programme. There was also a slight rise in medium term expectations of inflation, leading to real interest rates falling even further.

Risks

However, as Vernet (2015) indicates, the expected **impact** of assets on **prices** is going in the right direction, but we cannot know for certain if the initial responses of the markets will be transmitted to **spending by families and companies** and thus to rising **inflation.** We must be cautious as to whether we will finally see a clear effect on the real economy, as in Europe, unlike the US, there are certain obstacles to the transmission of monetary policy. Thus, loans in Europe are obtained through intermediary banks much more than in the US, so that the European banking system needs to be a good transmission channels and to improve access to credit. Similarly, the wealth of European families is less exposed to market movements than in the US.

Another risk of the long periods of monetary accommodation is faced by the companies which need medium and long term yields, such as insurance companies. Lower yields for all terms place these companies in a delicate situation, as they are limited in the products they can invest in and at the same time, cannot accept such low yields in order to maintain the sustainability of their businesses. On one hand, it is claimed that compressing margins due to low yields can have a negative effect on the provision of credit by the banks, and on their bottom line, in a period which is still precarious for the sector. These fears can be refuted, as Praet (2015b) does, stating that the net impact on the capital of the banks is positive: their improved solvency, thanks to better quality credit in their portfolios, lower financing costs and greater intermediation volumes, mean they should survive the impact of charging lower interest.

Also, as analysed by Berganza *et al.* (2014), there are risks associated with the process of monetary expansion which can condition the goal of price stability. As a consequence of the use of unconventional instruments, some agents in certain markets could be taking an **excessive risk**, favouring the appearance of new bubbles, without the lower financing costs leading to improvements in real investment. This is attested by the riskier investments being made by intermediaries such as insurance companies and pension funds, driven by the present long period of low interest rates. Jiménez (2008) provides evidence for the idea that in periods of monetary expansion, banks have a greater appetite for risk in the loans they issue.

On the other hand, the support of the Central Bank in the interbank market, providing liquidity within its monetary expansion programmes, could be leading some banks to **postpone the deleveraging and recapitalisation they need.** In these cases liquidity measures, rather than supporting the recovery of these financial institutions, could be masking solvency problems (Berganza *et al.*, 2014).

Another aspect to consider is that **unconventional actions can have significant distribution effects** (Dobbs *et al.*, 2013). Thus, managing to keep interest rates low contributes to mitigating the negative wealth effects arising from the crisis, although for savers it means a significant loss of income. Alongside this, the measures have an impact on long-term mortgage interest rates, which directly affect the distribution of family incomes, as analysed in Claeys *et al*. (2015).

Exit Strategy

Another important point is the risk associated with exit strategies and the questions arising in relation to them (see Berganza *et al.*, 2014). The design of exit mechanisms is a major **challenge**, given the size of the current monetary stimuli, the induced effects on financial markets and on other countries, and the scarcity of theoretical foundations and empirical evidence to enable us to anticipate the consequences of alternative strategies.

The biggest challenge will probably be restructuring the balance sheets of the central banks. The pace of normalisation of the balance sheet will essentially depend on whether the acquired assets are sold or kept until maturity (or prepayment in the

case of mortgage securities). If opting to sell part of these assets gradually and in an orderly fashion, the experience of the Bank of Japan in 2006 shows that this can be done without triggering greater volatility in the financial markets, and without a notable increase in the returns on those assets. On the other hand, keeping these assets for longer eliminates risk from changes in interest rates, and thus, possible loss of equity.

The different stages of monetary policies in the different areas of the economy mean that the US Fed will have to make the first move towards «normalising» its balance sheet and driving interest rates to slightly higher levels. Meanwhile, the Bank of England is also further along in this process, although it would be reasonable for it to start its exit later than the US. Finally, the ECB will face the challenge of the return to normality with knowledge of the strategies used by other central banks, and their consequences.

In any case, everything points to a long process, due to the significant volume of assets, a situation in which it will be important to encourage communication between central banks and avoid a sudden and unexpected rise in long-term interest rates, which could affect financial stability, capital flows and exchange rates around the world.

TABLE 3. IMPACT OF A TOUGHER MONETARY POLICY BY THE FED

The evolution of monetary policy in other economic spaces, most particularly the US, also has repercussions for the eurozone. Whatever the actual evolution of monetary policy in the US, in terms of interest rates, there can be no doubt that the next few years will see tougher monetary policies.

As described in the 2014 Annual Report of the Banco de España[32], if the Fed's interest rates rise more than 100 base points by the end of 2016 as predicted, this will bring with it increasing upwards pressure on long term interest rates in the eurozone, which could be from 0 to 100 base points, depending on the assumptions applied, with acentral scenario marking a rise of 25 base points in long-term rates (the differentials between the eurozone countries would be maintained).

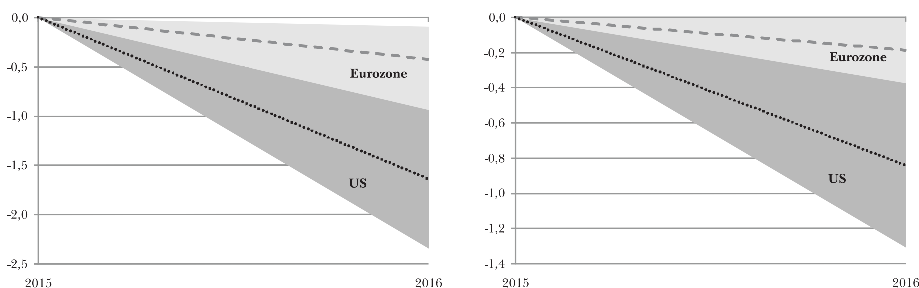
A negative effect is also estimated for the eurozone GDP, from .01 to over 1 percentage point by the end of 2016, although the estimated effect of this normalisation policy on the GDP of the US is much greater, with a negative effect of -1 to -2.5 percentage points, so that the divergence in growth between the US and the eurozone could be reduced to 0 by the end of 2016.

[32] The estimates are made according to the British NIGEM model, a quarterly macro-econometric model based on observed data, with economic variables including standard relationships. This model includes over 50 economic blocks, observing their interactions and reactions to the performance of each economic space. More information at: http://nimodel.niesr.ac.uk

The model also estimates an effect on the evolution of prices in the eurozone, this effect ranging from null to -0.4 on price growth by the end of 2016, although again, a much greater effect is estimated for the US, with a price increase calculated for the end of 2016 of 0.4 to 1.4 points lower than would be produced without this interest rate normalisation policy.

The most recent data from the 1-year forward interest rate in the United States[33] would suggest a slightly lower rise than the 100 base points considered by the model, which would also mean slightly lower fluctuation bands. In this way, as Graph 22 illustrates, the rise in interest rates anticipated by the forward would have a negative effect on the growth of GDP in the eurozone of -0.094 to -0.94 percentage points in relation to the growth that would be seen without the interest rate rise (the IMF estimates GDP will grow by 1.7% for the eurozone as a whole in 2016[34]). For the US, the negative effect would be more marked, at -0.94 to -2.34 percentage points in relation to the growth that would be seen without the interest rate rise (despite this, the IMF estimates an average 3% growth in the GDP of the US for 2016). Considering the forward interest rate, the effect on inflation would also be slightly less marked than estimated by the model (for the eurozone the effect on inflation would be between null and -0.37 percentage points, lower than what would be observed without interest rate movements in the US; meanwhile, in the US the effect would be between -0.37 and -1.31 percentage points in relation to inflation without changing rates).

GRAPH 22. GRAPH SHOWING THE DIFFERENTIAL EFFECT (IN PERCENTAGE POINTS) OF A RISE IN INTEREST RATES, IN LINE WITH THE US FORWARD RATE, ON GDP AND INFLATION IN THE EUROZONE AND THE US



[33] An average between June and September is considered for the daily forward data for the 1-year interest rate.

[34] Updated from the International Monetary Fund's *World Economic Outlook*, July 2015.

All the above is based on a main transmission channel, the exchange rate. To confirm, a tougher monetary policy will typically lead to a rising dollar, as a logical consequence of high demand for assets valued in dollars. In fact, the markets' anticipation of a toughening of US monetary policy has already led to a rise in the dollar in recent months (although there are other factors, such as different growth rates, inflation and risk perception). Also, historically we have seen that normally, interest rate rises in the US have been accompanied by rises in long-term interest rates in other countries (but with some exceptions, not in the so-called «conundrum»[35] of 2004 - 2006).

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[35] In 2005, the then Chairman of the United States Federal Reserve, Alan Greenspan, described as a "conundrum" the fact that rises in official interest rates (an increase of 150 base points) had not pushed up the interest rates on 10-year federal debt. Also, other markets were not affected, and there was no rise volatility, as Thornton (2012) reports.

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4. A YEAR ON SINCE THE START OF THE SINGLE SUPERVISORY MECHANISM: AN INITIAL ASSESSMENT OF THE SUPERVISORY ACTIVITY OF THE EUROPEAN CENTRAL BANK

Francisco Uría[1]

EXECUTIVE SUMMARY*

The implementation of the single supervisory mechanism was effectively commenced on 4 November 2014, with the European Central Bank becoming the direct supervisor of most Spanish banks.

From then onwards, the European Central Bank finalized its legal structure, internal organization and recruitment drive to ensure its capacity to carry out its new duties as supervisor efficiently.

Thus, the European Central Bank has a different governing structure for banking supervision from that responsible for monetary policy, with the sole exception of the formal competencies of the Governing Council, imposed by the Treaty and resolved by establishing an independent system for the solution of conflicts. Furthermore, it has a supervisory board and four Directorate Generals respectively responsible for managing the day-to-day aspects of microprudential supervision (Directorate Generals I and II), indirect supervision (Directorate General III) and specialized and horizontal tasks (Directorate General IV).

Spanish banks have noticed the change in supervision in their daily contact with the joint supervisory teams and the numerous formal and informal meetings held at board, director and board committee levels.

There has also been a change in the supervisory agenda so that new areas such as entities' corporate governance, risk management, business models, profitability or cybersecurity are now among the top priorities of supervision.

The supervisory assessment performed at the end of 2014 employed non-ECB methodology (i.e. that used by each competent national supervisor) because there was no time for the new supervisor to develop its own methodology. In 2015, however, the

[1] Public prosecutor on temporary leave. Associate responsible for the financial sector at KPMG.
* Full report in the Spanish version «Euro Yearbook 2015» available in www.fef.es and www.fundacionico.es

assessment has been performed with methodology drawn up by the ECB based on international best practices and its own concerns and priorities as supervisor.

The results of this first supervisory assessment will be known shortly and will determine, through requirements and recommendations made to the entities, the priorities for action by the banks and their supervisors.

The work analyses all of these matters, based on the documents published by the European Central Bank, its representatives' declarations in respect of banking supervision and the nascent bibliography on this subject matter.

The assessment of the work performed over the past year contained in this chapter is positive, taking into account the uncertainties that existed this time last year, before the results of the comprehensive assessment were known.

5. ADVANCES IN THE EUROPEAN RESOLUTION SYSTEM

María Abascal, Santiago Fernández de Lis, Rosa Gómez and José Carlos Pardo[1]

EXECUTIVE SUMMARY[*]

The resolution of distressed banks has been one of the areas of focus of the international financial reform in recent years, with two goals: (i) that banks can fail as other companies without creating a systemic problem and (ii) that it is not necessary to use taxpayers' money in their resolution. The G20 and the Financial Stability Board have laid the foundations for a new resolution framework in the general guidelines contained in the so-called «Key Attributes». Further development will culminate in a proposed ratio of total loss absorption capacity (TLAC) that has been adopted by the G20 in November 2015.

In Europe the changes in the bank resolution area have been profound in recent years as a result of the confluence of two processes: (i) the transposition of the global agreements referred to above and (ii) the progress towards Banking Union. While the former has generated a common regulation and harmonization of many aspects of the resolution framework for banks in the entire EU, while maintaining the principle of responsibility of the national authorities, the Banking Union has brought a much deeper integration between Eurozone countries with a common decision-making and a much more ambitious – albeit so far partial – mutualization.

The centerpiece of the new resolution framework is the bail-in tool, which implies that banks' creditors (particularly holders of senior and junior debt) are the ones to bear the losses in the event of resolution, instead of taxpayers. To ensure the application of this principle, a new regulation will require a minimum of liabilities with loss absorption capacity, through the establishment of ratios such as total loss absorption capacity (TLAC) for global systemic institutions or minimum required eligible liabilities (MREL) in Europe.

The institutional architecture of the Banking Union continued making progress in 2015. A single supervisor in the ECB was complemented with a new resolution authority in Brussels and the Single Resolution Fund. The latter is a very important element of

[1] BBVA Research.
[*] Full report in the Spanish version «Euro Yearbook 2015» available in www.fef.es and www.fundacionico.es

mutualization that highlights the progress towards a framework of shared sovereignty that clearly goes beyond that of the EU as a whole.

Further steps are necessary in the Banking Union, especially in two areas: the creation of a public support or backstop to give credibility to the Single Resolution Fund and the unification of the Deposit Guarantee Funds, to ensure that a euro deposited in a bank has the same value in any country in the Eurozone. The ultimate goal is that a citizen of any country can perform any operations with any bank in the area regardless of the country where its parent is located. It is a distant goal, but towards which we are making rapid progress. It is essential to maintain momentum and continuing making progress steadily.

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6. THE CAPITAL MARKETS UNION

IGNACIO DE LA TORRE[1]

EXECUTIVE SUMMARY*

This paper looks to address the processes and challenges that face the application of the Capital Markets Union (CMU), tabled by the European Commission (E. C.). Furthermore, it studies the motives behind the CMU proposal and its particular impact on the European debt and equities markets. Firstly the paper analyses the motives and advantages behind the CMU and why its application is necessary for healthier capital markets in Europe. The key motives are the need to reduce dependency on bank financing, and provide an alternative financing to give traction to the capital markets, and finally open up financing to SMEs that are dependent on capital for growth. The paper investigates the fundamental issues of supply and demand which are at the heart of the market plan, and puts forward the infrastructure that the E.C should adopt in order to achieve an efficient and applicable CMU to act as an alternative to bank financing and opening capital markets to SMEs.

The paper concludes by establishing the necessary elements for its successful implementation: they are i) the promotion of capital markets as means of improving alternative sources of finance, ii) the elimination of investment barriers for cross-border European investments, iii) the relaunching of the equity markets with simplified and standardized regulations across the union, iv) the mobilization of long-term savings in order to open up infrastructure projects, and v) to open a consulting period for the promotion of venture capital.

While the proposal is still in its early stages, there are fundamental policy issues that must be resolved between the E.C and the 28 member states, however if the steps mentioned above can be implemented, the dependency on bank financing can be reduced, and Europe can mitigate the effects of a financial and economic crisis and experience a quicker recovery in the event of future banking crisis. This will increase financial stability.

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[1] Associate of Arcano and Professor at IE Bussiness School.

* Full report in the Spanish version «Euro Yearbook 2015» available in www.fef.es and www.fundacionico.es

7. FROM A REFORM OF THE STABILITY PACT TO FISCAL UNION?

Pablo Hernández de Cos y Javier J. Pérez[1,2]

EXECUTIVE SUMMARY*

The successful progress of the European Monetary Union (EMU) calls for a tight coordination of national economic policies, most notably structural and fiscal policies. Indeed, since EMU inception the architecture of EMU established explicit coordination devices. In the particular case of budgetary policies the European Union Treaty included two basic coordination mechanisms, namely a no bail-out clause on national public debt by the other Member States, and a companion system of fiscal rules posing limits to public deficits and debt, operationalized through the Stability and Growth Pact.

The recent economic and financial crisis put the framework under significant stress, particularly since the sovereign debt crisis burst in mid-2010. The weaknesses of the framework were amplified by the absence of common crisis-resolution mechanisms and the fact that pre-crisis coordination mechanisms prevented to a very limited extent the accumulation of economic and fiscal imbalances. As a consequence, a number of bold policy actions have been taken recently to reinforce national and supranational fiscal policy institutions within EMU. First, by the end of 2011 the so-called «Six-Pack», introduced additional budgetary discipline instruments, most notably public expenditure rules and the operationalization of convergence to public debt limits. Then, the «Fiscal Compact» asked Member States to incorporate into national legislation common rules governing structural public deficit targets and corrective mechanisms to cater for deviations, while the «Two-Pack» granted the European Commission (EC) strengthened powers to monitor national budgetary policies, including coercive powers, and put forward the creation of national fiscal councils. In addition, the European Stability Mechanism, a permanent-basis crisis resolution device was established in early 2011. More recently, the Five Presidents' Report sets out plan for strengthening Europe's Economic and

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[1] Pablo Hernández de Cos in currently General Director of Economics and Statistics and Member of the Executive Committee of Banco de España Alternate Governor on the Governing Council of BCE.

JJ Pérez is Responsible for the Unit of Fiscal Polity fiou Studies Service and Banco de España.

[2] The opinions expressed in this article are responsability of the authors and therefore do not necessarily coincide with those of the Bank of Spain or the Eurosystem.

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Monetary Union as of 1 July 2015. This ambitious report covers the economic, financial, budgetary, political and social dimensions. In the particular case of steps «towards a Fiscal Union», the five Presidents propose the creation of an advisory European Fiscal Board (EFB) in the short-run, while in the longer term they propose a common macroeconomic stabilization function to make EMU more resilient to shocks, and even the consideration of a common Treasury for EMU countries. In October 2015 the EC took concrete steps to develop the proposals of the report, in particular by setting up an independent advisory EFB.

Overall, to our view, and notwithstanding the still limited evidence, the reformed fiscal rules' framework has to be assessed positively, most notably the provisions affecting public spending and debt rules, the reinforced ex-ante and ex-post coordination framework and the introduction of national fiscal authorities. Nevertheless, at the same time, the increased complexity of the system may blur transparency and accountability in its application, and despite steps towards a more automatic application, ample margins of discretion persist in the interpretation and implementation of rules by the EC. In this respect, further work is still needed to simplify the rules and make their implementation more automatic. As regards the EFB, its main challenges lies in building up its credibility as a fully independent fiscal watchdog, without a cloud of interference from, in particular, the EC.

Beyond the latter specific issues related to fiscal rules, the main challenge ahead for fiscal governance lies precisely in the distance between the current framework and a genuine Fiscal Union. Weaknesses arise from the absence of common tools to cushion adverse shocks affecting one single Member State or a group of them, particularly to face confidence-related episodes like the one witnessed during the recent sovereign debt crisis. Fiscal-financial backstops, like a common EMU budget or common debt issuance schemes are still too far from being in the pipeline. While steps to complete a genuine banking union and capital market integration are instrumental to cushion shocks within a monetary union, the development of the common macroeconomic stabilization function proposed for the medium-run remains crucial for proper risk-sharing within EMU.

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8. THE INVESTMENT PLAN FOR EUROPE AND THE EUROPEAN INVESTMENT BANK

Román Escolano[1]

EXECUTIVE SUMMARY*

Europe's competitiveness and long-term, sustainable growth potential suffer from underinvestment in important areas. There is an increasing innovation gap that makes Europe's position in a globalized world even more challenging. With the Investment Plan for Europe (or so-called «Juncker Plan») we now have an instrument in place to address this investment gap. The Investment Plan for Europe is a key EU-level policy tool, designed to give a firm push to competitiveness-enhancing strategic investment. The objective is to mobilise additional investments for an amount of EUR 315 billion. The key vehicle for the Juncker Plan is the new European Fund for Strategic Investments (EFSI). EFSI, a managed account by the EIB Group with a total amount of EUR 21 billion, is expected to mobilise investments in Europe for EUR 315bn. However, the EIB activities cannot substitute the fundamental precondition of having the Member States implement reforms for achieving an investment friendly regulatory framework.

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[1] Vicepresident del Banco Europeo de Inversiones.
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9. GREECE: THE ROLE OF THE EUROPEAN INSTITUTIONS AND THE IMF IN THE CRISIS

José Manuel Amor y Víctor Echevarría[1]

EXECUTIVE SUMMARY*

The analysis of the Greek crisis reveals the difficulties of coping with an asymmetric shock within a monetary union. The lack of appropriate mechanisms within the Eurozone to deal with such shocks and the specific vulnerabilities of Greece led to a long and painful crisis. The article reviews the experience of Greece and its creditors to shed light on the causes of the crisis and a possible way forward. A combination of structural deficiencies, the underestimation of fiscal multipliers and an overly optimistic assessment of the underlying economic situation in Greece led to a deficient design of the rescue packages.

The culprit lies, partly, in the way policy reacted to the strong growth rates in Greece before the crisis. In particular, fiscal deficits remained high and debt stabilized at about 100% of GDP even as the economy grew at close to 3%. Also, this period was characterized by a worsening business climate, as assessed by the international institutions, which in turn lowered potential growth and made Greece vulnerable to the global financial crisis.

In this context, Greece had little fiscal space when the crisis struck. The rise of risk aversion in financial markets, worsening economic prospects and higher debt than had previously been acknowledged led to rating downgrades and increasing yields. Eventually, the Greek Government announced a fiscal adjustment package in early 2010 to improve debt dynamics. However, the deterioration of fundamentals continued and the Greek government had to ask for a bailout.

The bailout announced in 2010 was the first of three bailouts in Greece. The conditions attached to these bailouts evolved over time, as the weaknesses in their design were revealed. In particular, while the first bailout did not involve debt restructuring and relied on structural reform and fiscal adjustment to improve debt dynamics, lower than expected growth and high fiscal multipliers led actually to increasing debt. The prospect of restoring market access remained elusive.

As a result, the second bailout, agreed in 2012, introduced private sector involvement, by which private creditors accepted a haircut on their holdings of Greek debt. Also, the policy mix shifted slightly, lowering the fiscal adjustment required while remaining ambitious regarding structural reforms. However, the slow progress in the

[1] Director and senior consultant from Economic Analysis and Market Area of AFI.

* Full report in the Spanish version «Euro Yearbook 2015» available in www.fef.es and www.fundacionico.es

implementation of the program, and the limited improvement of the economic situation led to a heightened political tensions and less will to complete the reforms in the program. In the end, early elections were called.

The election of Syriza in early 2015 on an anti-austerity platform led to a confrontation with the creditors. As a result, the financial situation of Greece deteriorated sharply. With the Greek banking sector close to the brink, the agreement on the third program was only reached in mid-2015. However, certain aspects of the conditionality of the third bailout remain contentious, and the completion of the program is subject to further negotiations. One aspect that is particularly difficult is the need for a form of debt restructuring to reduce the debt burden and improve debt dynamics in Greece.

Overall, the reasons for the Greek experience during the crisis are wide ranging. The lack of restraint on public spending in the upturn, and the absence of structural reform may the subsequent adjustment more difficult. Once the crisis struck, the creditors overestimated the effect that structural reform would have on growth. Also, crucially, fiscal multipliers were underestimated. The adjustment process in a monetary union, without the possibility of a devaluation, was a lot more contractionary. The result was a recurrent deviation of the path of debt from the set target.

As time went by, and a tough fiscal adjustment and the reforms implemented did not lead to an improved outlook, the public support for the bailout eroded quickly. As a result, the political situation became more difficult, and the implementation of the program less ambitious. The lack of ownership of the program further dented its implementation.

Going forward, a bold agreement that comprises strong structural reforms and a realistic assessment of debt sustainability and the need of debt structuring is necessary. Only if the Greek Government feels ownership of the program, and assesses that, at least in the long run, the program is good for its economy, will its implementation be satisfactory.

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10. THE OUTLOOK FOR SOVEREIGN DEBT IN THE EURO AREA

Ángel Ubide[1]

EXECUTIVE SUMMARY*

The financial crisis has driven sovereign debt within the developed world to alltime highs as automatic stabilisers kick in, counter-cyclical fiscal policy takes effect and nations are forced to bail out the financial sector. Coupled with an outlook of muted growth and with fiscal accounts feeling the pressure of an ageing population and the rise in healthcare spending, there is now growing uncertainty as to the ability of developed nations to honour their debts.

In the specific case of the euro area, the panorama is aggravated further by the errors committed during the crisis. The Deauville Declaration, which opened the doors to defaulting on debt obligations, together with the extreme initial reluctance shown by the ECB in implementing a quantitative easing policy, and the long and confusing process of restructuring Greek debt, has created an uneasy scenario whereby a developed nation may not have to repay its debts and this is something economic agents must take on board when devising their risk management models. This actually changed the nature of bonds across the peripheral euro area, which under stress conditions began to function as credit rather than debt. For these countries, any drop in their growth outlook triggered sharp interest rate rises as markets began to focus more on the increasing likelihood of default than on their weaker forecast growth. This has generated uncertainty as to how the spread between the growth rate and interest rates in the euro area will pan out; a key factor shaping the debt environment.

The fact that the economic structure of the euro area is incomplete has only increased this uncertainty. The original combination of a «no bail out» clause with a prohibition on financing deficits by monetary means and the absence of Eurobonds has given rise to an «impossible trinity» that has generated confusion across the markets, weak and poorly timed responses in terms of economic policy, and a high cost in terms of growth. This goes a long way to explaining why the euro area has experienced the longest recession among all G7 members.

The high levels of debt are indeed worrying, since they could negatively impact growth through the «debt overhang» effect and by making countries more vulnerable, in

[1] Senior Fellow, Peterson Institute for International Economics.

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that they will find it harder to implement counter-cyclical policies and increase the primary surplus needed to stabilise the debt ratio. The higher the debt, the greater the risk of slipping into a negative balance. As a result, the average longterm output gap becomes negative as economic policy can no longer respond as it should do.

These risks have led to various recommendations on restructuring the debt of euro area countries by treating their sovereign bonds as risk assets. These proposals are well off the mark and could have an extremely detrimental impact on the euro area in the mid term. This article argues that instead of tackling the high levels of debt through restructuring aimed at reducing the volume of debt, a better approach would be to manage future debt service flows by rolling out a fiscal union involving the creation of a system of what we might call «stability bonds». This would allow the debt to be refinanced while lowering the risks of sudden stops in capital flows as we maintain market discipline to keep moral hazard at a bare minimum. Stability bonds would enable national fiscal policies to support growth during a crisis, and would also create an instrument capable of generating a fiscal stimulus across the entire euro area. The system would also create a risk-free asset with which to diversify bank balance sheets in the euro area and would lead to the creation of pan-European banking groups. This would in turn create the right conditions for credible compliance with the «no bailout» clause and complete the economic structure of the monetary union. The upshot would be a euro area much more ready for the next recession and an increase in potential growth across all euro area countries.

11. THE SUSTAINABILITY OF THE MONETARY UNION AS SEEN BY THE EMERGING ECONOMIES[1]

Alicia García-Herrero[2]
David Martínez Turégano[3]

EXECUTIVE SUMMARY*

The establishment of a single monetary area in Europe at the end of the 20th century was a disruption in the traditional approach of economic integration processes consisting of trade liberalization and the reduction of tariffs. The creation of a common currency for 11 countries, which implied the use of a single monetary policy and the loss of the exchange rate as a policy tool for economic adjustment, only finds a comparable precedent in the birth of the dollar and of the US itself at the end of the 18th century.

The balance of the first decade of the Economic and Monetary Union (EMU) was positive in terms of growth and price stability, a fact that drew the interest of other integration processes around the world, particularly in the Asia-Pacific region. Rapid economic growth and the increase of relations between countries in the area brought forward the debate on adopting a single currency.

However, the ongoing economic recession in the EMU and, on top of that, the problems that have arisen due to a flawed design of the single monetary area, have cooled down the discussion. Once the positive impact of the financial shock generated by the creation of the EMU has faded away, structural divergences among country members have come to the spotlight. These divergences constitute significant bottlenecks for recovery and have required an unprecedented review of the institutional framework. A debate on optimal monetary areas was held when preparing the roadmap for the EMU during the 90s and is well alive again at present.

The goal of this article is to assess, on a comparative perspective from the experience of the EMU, the two most promising ongoing integration processes in the emerging world, i.e. the Association of South-East Asian Nations (ASEAN) and the Pacific Alliance. In the first section we describe the current degree of integration and the goals set for the following years, while in the second section we broadly analyze the degree of nominal and real convergence between the countries of both blocs, as well as the sensitivity of the economies to external shocks. A final section of conclusions closes the article.

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[1] The opinions contained in the signed articles are from the authors and they do not express the points of view of the institution where they develop their professional work.

[2] Senior Researcher fellow at RIELCANO and BRUEGEL.

[3] Staff Economist at Bank of Spain.

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12. BREXIT – ECONOMIC AND LEGAL IMPLICATIONS

PHILLIP SOUTA[1]

EXECUTIVE SUMMARY*

Those currently pushing for a Brexit have yet to offer any kind of proper explanation of the future relationship between the United Kingdom and the European Union following the UK's departure and, perhaps more importantly, the extent to which British law emanating from Europe would be repealed. The disadvantages of a Brexit are therefore identifiable and quantifiable, whereas the benefits are currently unknown.

With this in mind, this chapter examines the possible postBrexit scenarios:

- Membership of the European Economic Area (EEA) and the European Free Trade Association (EFTA) as per the Norwegian model;
- Bilateral agreements and EFTA membership as per the Swiss model;
- Customs Union as per the Turkish model;
- Free Trade Treaty between the United Kingdom and the European Union;
- Membership of the World Trade Organization (WTO).

There are also other areas of the United Kingdom that could be affected by a Brexit both in a legal and business sense. As a result, this chapter also addresses the fiscal, tax, employment and commercial ramifications, plus the possible impact on competition.

In principle it should be easy to go over the pros and cons of the different scenarios discussed in this chapter. In practice, however, it is much more difficult a task given the uncertainties and interdependencies between them.

An important characteristic to bear in mind in any scenario in which the UK remains an EU member is the extent to which it will be retain decisionmaking control and freedom to change policies or tactics to further its own national interests.

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[1] Head of Public Policy, Clifford Chance LLP.

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The common denominator present in all five scenarios wherein the UK leaves the European Union is the pattern of risk, longterm commercial and trade uncertainty and a lack of control. Exiting the EU would take time and the ultimate outcome is far from clear. Following its departure, the UK would be at an impasse and would have to await the results of the regulatory changes made to the Treaties of the European Union, which would certainly have a huge impact on trade relations between the UK and the EU.

During the decades to come, the future relationship between the UK and the EU could include or feature any of the elements analysed under any of the eight scenarios discussed in this chapter, and it is also entirely possible that the future reality could have different and currently unforeseeable consequences in store.

Following the nation's exit, the UK government would also have to reach difficult decisions on how best to adapt the British regulatory se-up to a postBrexit scenario. It would mean having to devise a programme that could well span two general elections. The United Kingdom would have to embark on one or more of the post-Brexit options open to it, attempting to negotiate either before or after it leaves, or even through a process of trial and error in negotiating with those Member States also affected by its departure in a bid to seek out alternative solutions. All these steps would be immensely difficult from a political, technical and diplomatic standpoint and could well take years, during which time the UK's global trade outlook would remain uncertain.

In the field of financial services, is Brexit really a better option than remaining an EU member? All things said, the creation of an integrated EU framework for financial services has had a marked and extremely positive effect for all UK-based financial services that have a European or global scope, and with an equally positive impact on customers. It is easy to take for granted the benefits of this common legal framework and the legal freedoms it represents, which have been developed and shaped over the last 40 years or so. However, without this common framework, the trade dealings of UKbased financial service companies could either stop or relocate to a different hub outside the European Union. Without this framework in place, companies from other EU member states would no longer be so keen to set up in the UK, while the authorities of their home country (which would then view the UK as an offshore jurisdiction) might refuse to allow it without further regulatory guarantees. Nowadays, the City functions as a natural market embracing both EU and foreign firms. This is made possible by the internal market legislative framework it offers. The United Kingdom, bac-ked by its enormous experience in financial services, would certainly be able to maintain its huge influence in this regulatory field but only if it shows that it is genuinely committed to it. Relinquishing this position of strength to try out some other as-yet untested, unknown, or unpredictable alternative would entail significant risks.

Of the various scenarios analysed in this chapter it is clear that from a legal standpoint the UK's ongoing status as a leading financial hub would be much safer if it remained within Europe and implemented the necessary reforms.

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