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Monetary Policy and Prudential Regulation in Europe

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"Investors are again thinking that central Banks will use ammunition that many had concluded was exhausted after years of interest-rate reductions and bond buying"

Mark Carney, Governor of the Bank of England, quoted in the FT on 4th July 2016

"Banks have been weakened by a combination of slow growth, low rates, regulatory tightening, and compression of capital ratios as financial stock prices have plunged – especially in the wake of Brexit"

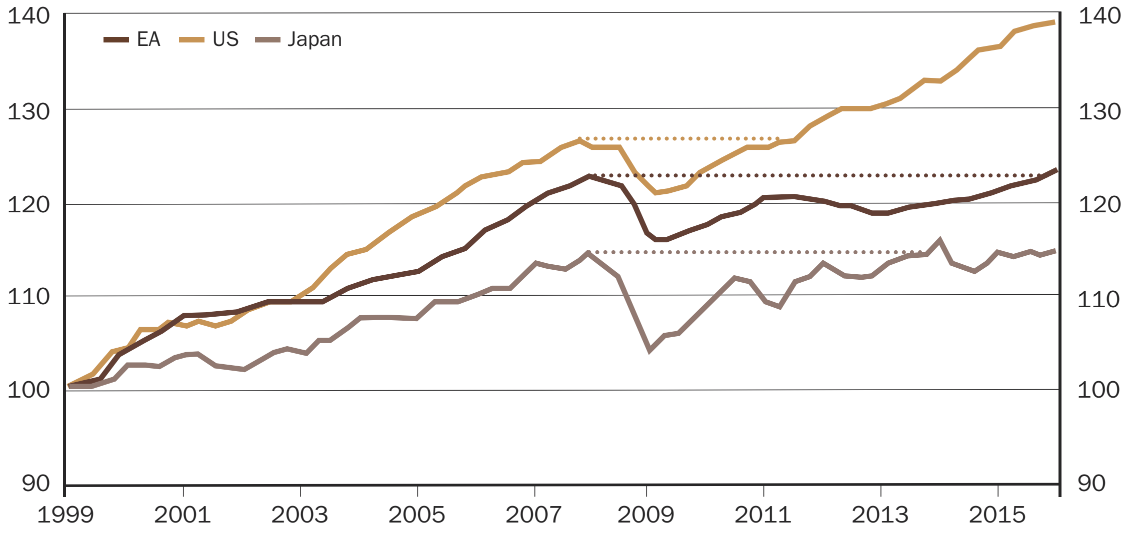
"The World after Brexit", Global Economic Research, Deutsche Bank. 6th July 2016

1. The Problem[1]

The economic results in Europe after the financial crisis are extremely disheartening. It is surprising that an originally American crisis should have had a significantly more serious impact on economic activity in Europe than in the United States (Graph 1) and that the Eurozone should still be battling to recover the levels of activity witnessed before the crisis. This difficulty in terms of recovering acceptable growth levels and, above all, levels of employment that are socially sustainable, lies at the heart of many of the political difficulties that have blighted the European integration project.

GRAPH 1.

Real GDP (Index, 1999Q1=100)



Sources: Eurostat, BEA, Cabinet Office, ECB calculations.
Notes: horizontal dotted lines represent pre-crisis peak real GDP level. Latest observation: 2016 Q1

[1] I would like to express my special gratitude for the comments, suggestions, criticisms and disagreements received at the seminar held at the FAES Foundation in the month of July 2016. Although I am solely and exclusively responsible for the text and its conclusions, there is no doubt that this article improved a great deal thanks to the contributions of all the participants.

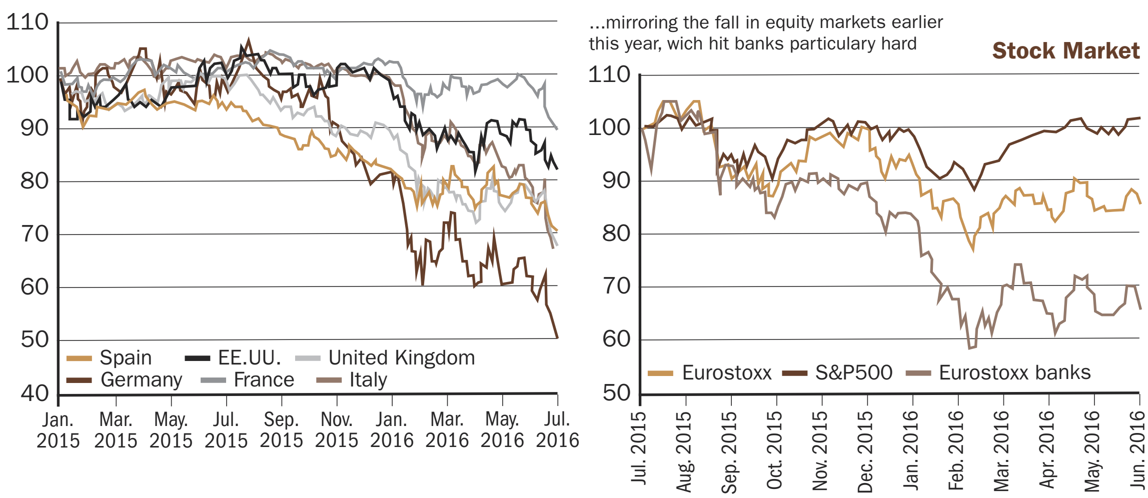
"An originally American crisis has had a significantly more serious impact on economic activity in Europe than in the United States and the Eurozone is still battling to recover the levels of activity witnessed before the crisis"

The truth is that Europe has not departed much from the consensus established at the G-20 meeting in London in April 2009, which defined the global policy response in order to restore confidence and pave the way for recovery. In short, a three-pronged economic strategy was agreed at the meeting: unprecedented monetary expansion, lowering interest rates as much as necessary and contemplating special liquidity expansion measures; greater financial regulation, based on higher capital and liquidity requirements at financial institutions, improved risk management systems and models, and a greater emphasis on the governance of simply banks in order to reduce the frequency of crises and ensure that they are less costly to the taxpayer; and strong fiscal expansion wherever this may be permitted based on the sustainability of the public accounts. This political response meant that a large part of the cost of the adjustment fell on the financial system, which is why it is not surprising that the banks have suffered more than other economic sectors in terms of their stock market capitalisation (Graph 2). What is, perhaps, most surprising, and certainly requires some kind of explanation, is why the European banks have suffered greater losses than the US banks.

Europe's political policies, despite its traditional do-nothing image, have not differed that much from those agreed at the G-20 summit, although it is true that they

GRAPH 2.

Relative performance of the banking sector. Base 100 January 2015



Source: Euro Area Policies, IMF Country Report Nº 16/219

[2] Maluquer de Motes, J. (2016), España en la economía mundial. Series largas para la economía española (1850-2015), Madrid, Instituto de Estudios Económicos.

> **"A large part of the cost of the adjustment has fallen on the financial system. The banks have suffered more than other economic sectors in terms of their stock market capitalisation"**

took some time to be adopted and were applied with all the institutional characteristics typical of a Europe that is still under construction. However, the different national governments have abused Europe when it comes to finding someone to blame for their economic plight, thus promoting a growing public disenchantment with the European idea. Europe has been publicly blamed for the delays in applying the inevitable policies, for the design errors in the policies themselves, for the failure to fulfil these policies and even for its lack of credibility when it has failed to take action in the face of non-fulfilment. However, these same policies have witnessed some very different patterns on the part of the various national governments, depending on the quality of the countries' political and institutional establishments, their degree of commitment to applying the policies in question and their will and capacity to accompany such policies with structural reforms. The period between 2007 and 2014 was the most negative in Spain's economic history in terms of the year-on-year variation of its GDP. Never before, except for war-time periods, has the per capita GDP rate been so contrary with regard to general prosperity.[2] Likewise, the recovery between 2014 and 2016 was truly astonishing and only comparable to that of Ireland, a country that is known for its exceptional flexibility.

If there is one European institution that has been at the very epicentre of the storm throughout this period it is the ECB (European Central Bank). A saviour for some and an irresponsible accomplice for others, the truth is that the ECB has acquired an enormously important role in the absence of any other European authority of its kind, probably because it is the only federal European institution that possesses clearly-defined powers. However, its growing role has also highlighted the institutional weaknesses of the European Monetary Union. This article seeks to provide a critical and dispassionate analysis of the BCE's activities during this troubled period in Europe's history, focusing on its two basic functions: monetary policy and financial regulation and supervision. In both cases, the ECB has entered unexplored territory, in the company of the main central banks and international financial authorities. Nevertheless, these alliances should not cloud our judgement or restrict us in any way, especially in view of the fact that one of the main lessons of the financial crisis is the need to avoid unanimous stances and grant a voice to opinions that run against the dominant view.

In its attempts to address a crisis that was not essentially a monetary matter, the ECB has taken on a leading role that did not really correspond to its remit. And by doing so it has entered territory that is new to it, that of political economics, a game that is not necessarily cooperative. The instruments set up to re-found Monetary Union after the crisis (mainly a banking union with centralised regulation, supervision and resolution at a Europe-wide level; and certain advances in terms of fiscal union, based on the strengthening of European discipline and the European Stability Mechanism, with OMT's serving as embryonic structural adjustment funds), may alleviate financial tensions, but they cannot be used to tackle the political risks that derive from the lack of will to undertake reforms. Europe's problems are structural and monetary policies cannot resolve them, no matter how creative they are. "Europe faces more of a political crisis than a banking or debt crisis. In these conditions, monetary policy is close to its limits and firm measures are required on other fronts: the early resolution of banking problems in Italy and Portugal, better coordination of national fiscal policies and a greater emphasis on a European public investment policy"[3].

2. The ECB's Monetary Policy: The Path Towards Heterodoxy

The main monetary policy decisions made by the ECB are well-known and there is no point in repeating them here. It is sufficient to say that the ECB has gradually changed, perhaps more slowly than the main central banks throughout the world, but in a similar manner. It has gone from a traditional approach based on easing interest rates towards a direct intervention model, first by guaranteeing financial institutions infinite liquidity at zero cost by means of the programmes known as LTRO and TLTRO, and then by directly purchasing both public and private financial assets in order to bring that liquidity to governments, companies and individuals without any intermediaries, all as part of an attempt to compensate for a bank transmission mechanism that is not working properly. This is a consistent strategy, but one in which, to be entirely coherent, the ECB has fallen somewhat short when it comes to taking on private credit risk. The only thing that remains for the ECB to try is purchasing private equity on the secondary market, as other central banks such as those of Japan and Hong Kong have done in times of recession and possible deflation.

The main milestones of the ECB's monetary policy, as outlined in the Bank of Spain's Annual Report in 2015, are briefly presented below and can be broken down into four different policies.

I. Reduction of official interest rates
  - Marginal credit facility: 0.25%
  - Main financing operations: 0%
  - Deposit facility: -0.40%

[3] "Europe in Unchartered Territory", European Economics Quarterly, Barclays Research, 2016. This report offers a good summary of the consensus on the markets after Brexit, an unexpected event that has served as a catalyst regarding the uncertainties and vulnerabilities that existed beforehand.

II. Long-time financing of the banking systemo
- TLTRO and TLTRO II

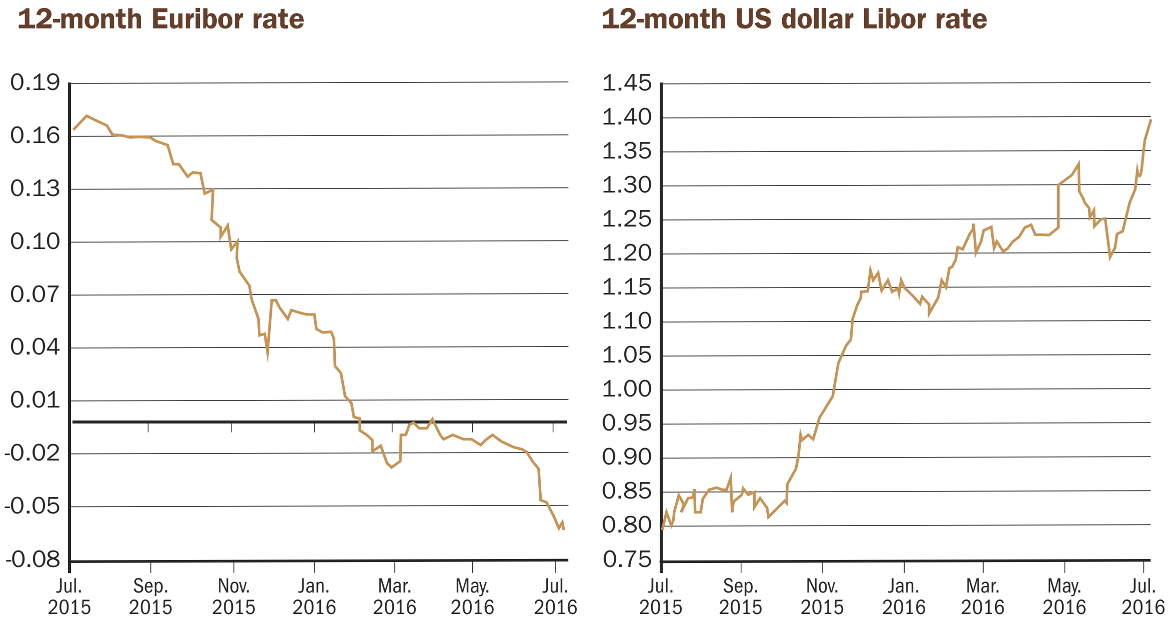
III. Asset Purchase Programme (qualitative leap in 2015):
- CBPP3, ABSPP, PSPP, CSPP. The characteristics of the different programmes are described in the table below

IV. Guidance regarding the future course of monetary policy (*forward guidance*)

	CBPP3 Covered bond purchase programme	**ABSPP** Asset-backed security purchase programme	**PSPP** Public sector purchase programme	**CSPP** Corporate sector purchase programme
	Private debt	Private debt	Public debt	Private debt
Type of security	Covered bonds (of the mortgage-bond type in Spain)	Simple and transparent asset-backed securities based on credit for the non-financial private sector	Bonds issued by Central Government, agencies and international institutions located in the Eurozone. In December 2015 the programme was extended to include bonds issued by Regional and Local Government in the Eurozone	Non-bank corporate bonds
Market	Primary/secondary	Primary/secondary	Secondary	Primary/secondary
Announced/ commencement	Sept./Oct. 2014	Sept./Dec. 2014	Jan/March 2015	March/June 2016
End	At least March 2017 (extended in Dec. 2015 from the initial date of Sept. 2016)			
Volume of purchases	60 million euros a month between March 2015 and March 2016; 80 million euros a month as of April 2016			
Reinvestment policy	The amounts due are reinvested for as long as may be required			

The initial effects of this special monetary policy and its intensification in 2015 with the asset purchase programme can be observed in Graph 3, where the 12-month Euribor rate fell in one year from the positive but already extremely low rate of 0.16% to the all-time low of -0.08% witnessed in June 2016. The ECB thus broke through the psychological and physical barrier of having a negative rate as the most usual index of reference for financial operations, a barrier that the US Federal Reserve has not broken through and does not seem likely to, given that the 12-month Libor rate in dollars stands at 1.45%, having reached an all-time low of +0.8% around a year ago and then having risen since then (Graph 3). For the moment it is sufficient to point out that negative rates mean that savers must actually pay in order to save. Applied to private operations, this would mean that 12-month deposit-holders would have to pay their bank to hold their money for them, something that has already occurred in certain Nordic countries and that some Spanish financial institutions are considering for their wholesale and institutional clients.

GRAPH 3.



Source: Bankia Estudios

In order to gain an idea of the extraordinary magnitude of the ECB's intervention we should take into account that the balance of the monetary authority comes to some 30% of the EMU's GDP figure, the excess liquidity of the financial institutions regarding legal reserve requirements comes to more than €900 billion and is higher than the figure achieved during the first quarter of the year 2012, and Spain's negative Target balance comes to more than €300 billion, also approaching the levels witnessed during that first quarter of 2012, prior to Spain's agreement with the Eurogroup (Graph 4)[4].

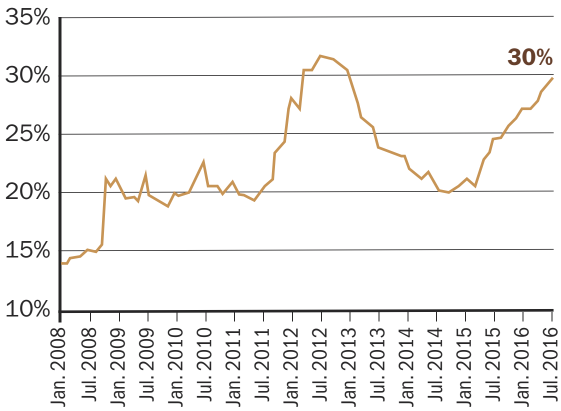
2.1. Arguments That Justify a Monetary Policy Based on Quantitative Easing

Such a heterodox and extraordinary monetary policy cannot have been simple to implement. In fact, economists and central bank specialists have been arguing for years over the arguments that justify it. Without wishing to be exhaustive, five main reasons have been cited to support such as approach. Let us briefly consider each of these arguments.

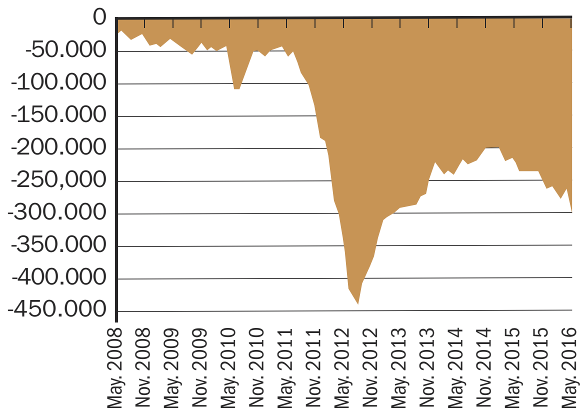
[4] Although it is true that the excess liquidity and Target deficit levels are similar to those of that fateful first quarter of 2012, our interpretation should be completely different. In 2012, Spain had lost access to the private capital market and the sole source of financing for companies and the public sector was the ECB. Today, these liquidity levels are a reflection of the fact that investors are not demanding the liquidity that the ECB places at their disposal, in spite of being penalised for it.

GRAPH 4.

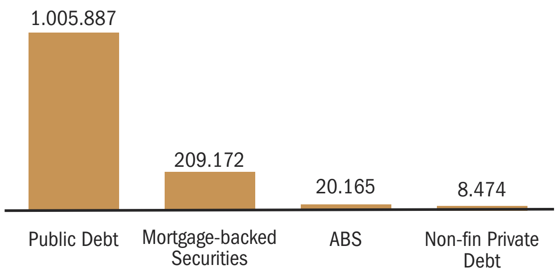
EMU GDP balance



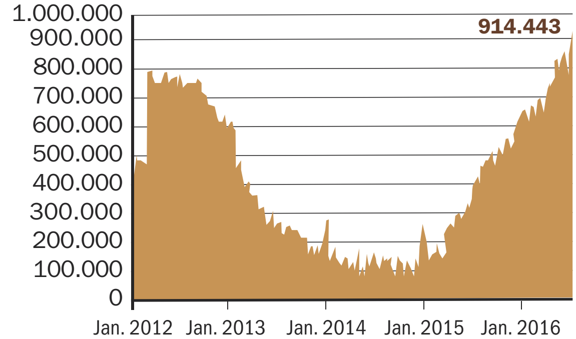
Spain: TARGET Balance



Total volume purchased (million euros)



Excess Liquidity (million euros)



Source: Bankia Estudios, July 2016

I. The Secular Stagnation Hypothesis

According to certain authors, normally from the United States and initially from the circle surrounding Larry Summers[5], the world is moving towards a long period of low growth based on poor productivity, an ageing population, a savings glut and, recently, deteriorating income distribution.

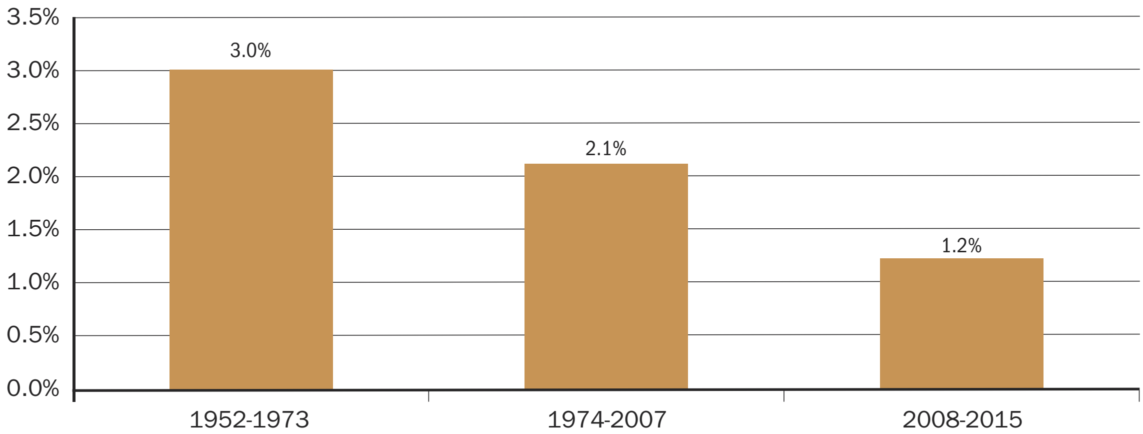
This hypothesis is highly attractive in terms of explaining the poor performance of OECD member countries, especially the paradoxes of productivity. In this respect, in spite of a technological revolution that has been quite unprecedented since the Industrial Revolution, the United States has witnessed a per capita output figure that has been declining since the 1950's (Graph 5), a trend exacerbated in Europe by its well-known structural problems that have caused it to lag behind,

[5] Summers, L. (2016), "The Age of Secular Stagnation: What It Is and What to Do About It", *Foreign Affairs*.

"A saviour for some and an irresponsible accomplice for others, the ECB has acquired an enormously important role in the absence of any other European authority of its kind"

GRAPH 5.

U.S. Average Productivity Growth (Nonfarm Bisiness Sector Real Output per Hour- All persons)



Source: U.S. Bureau of Labor Statistics

except in the agricultural and building sectors (Graph 6). This has not been true in other parts of the world, perhaps because the technological revolution has ended the West's privileged access to information and know-how.

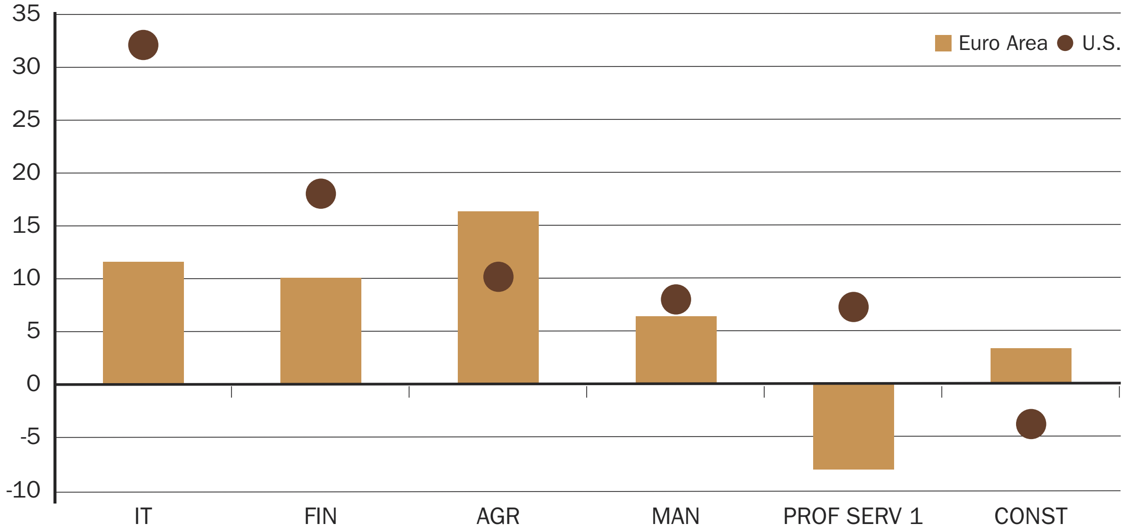
However, any talk of a savings glut seems an exaggeration when overall public and private debt has not ceased to grow since the 1960's and is still higher than the debt figure recorded before the financial crisis, as highlighted by the Bank for International Settlements (BIS) and as reflected in Graph 7. The same could be said of the ageing population, which is really a Western problem. We are therefore dealing with a thesis that pertains to the North Atlantic and possibly describes the secular stagnation of these countries' respective economies, even though it does not necessarily describe a worldwide situation[6].

Whatever the case may be, this secular stagnation hypothesis is frequently used to justify especially low capital yields. If productivity is low, then capital yields and

[6] The problem of income distribution and its impact on secular stagnation and on the effects of monetary policy is too complex to be dealt with here. Those interested in this question can refer to the study entitled Desigualdad, Oportunidades y Sociedad de Bienestar en España (Fundación Faes, 2015), which tackles this matter in depth and concludes that the main cause of inequality in Spain is unemployment, which, in turn, is not the cause of mediocre economic growth, but the consequence.

GRAPH 6.

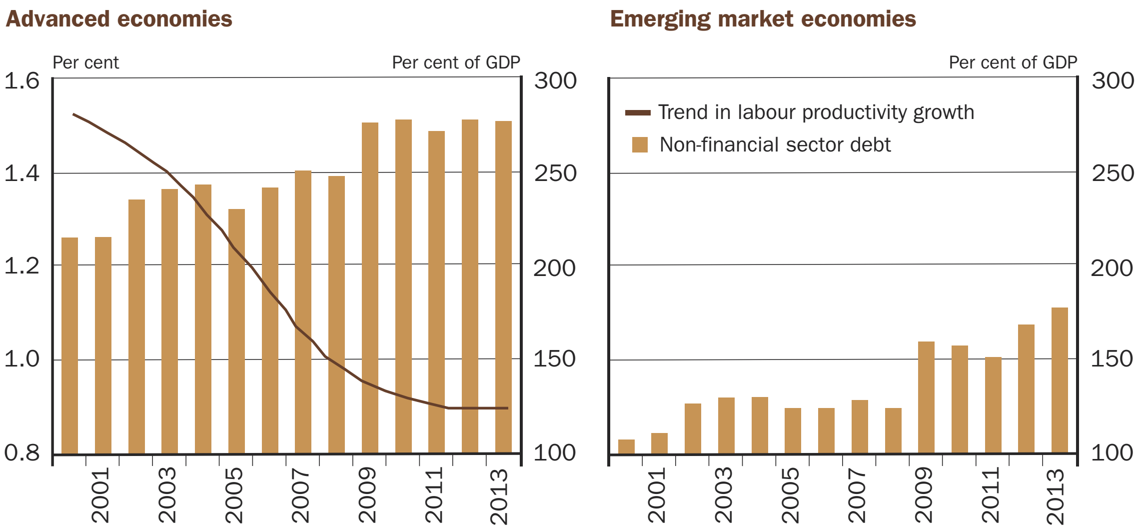
Productivity by Sector (2007-2014, average annual percent change)



Source: IMF, Euro Area Policies, art IV Staff Report, July 10, 2015
Note: 1/ For the US, the category of professional and business services is used, while for EA countries the sector is professional, scientific and tech activities

GRAPH 7.

First Transition: Towards a Less Debt-Intensive Model



Source: J Caruana, Stepping out of the shadow of the crisis: three transitions for the world economy, 2014 BIS, AGM, General Manager Speech, Basel, June 29, 2014

“Europe’s problems are structural and monetary policies cannot resolve them, no matter how creative they are”

natural rates of interest are also low. Levels close to zero are not the consequence of any special policy, but a structural characteristic of developed economies within a new and normal climate, one that monetary authorities would do well to accommodate. However, we could be mistaken in our diagnosis and it could be that stagnant productivity is simply a reflection of the structural rigidities of production and employment in developed countries. That is to say, we could be dealing with a supply-side problem that we are attempting to resolve with a series of increasingly heterodox demand-side policies. Or perhaps we are not even faced with a problem, but merely witnessing the undesired consequences of the social preferences of rich communities that do not value economic growth, but seek to ensure stability and the perpetuation of the current *status quo*.

II. The Threat of Deflation

Developed economies have been witnessing inflation levels that are too low for years and rates are clearly below their target level. This is so much the case that many central banks, and notably the ECB, have deemed it appropriate to review their mandate, or at least revise the traditional interpretation of that mandate, in order to make it clear that their objective is not to situate the rate of inflation below 2%, but at around 2%, thus establishing something similar to a desirable settling-point for inflation. The manual for monetary authority orthodoxy thus reflects an idea that was quite controversial when it was initially formulated by Dornbusch and Fischer in the early 1990’s: moderate inflation, which they established at around 5%, was desirable in the sense that it greased the wheels of the economy. What is more, it did not necessarily generate explosive processes whereby social agents sought out income, salary rises or any other increases. This is because, as enshrined in an old Keynesian idea, prices and salaries are ‘sticky’[7] and the cost of reducing inflation below that level in terms of lost output is excessive.

The fact is that, what in the 1990’s seemed something of an academic curiosity, has now become a reality in the first decade of the 21st century. Inflation within the Eurozone is at an extraordinarily low level, with the harmonised rate standing close to 0% since 2015 and underlying inflation coming to below 1%. It is not surprising, then, that there should be so many voices that are calling for special policies to address special situations. The monetary authorities have been placed

[7] Dornbusch, R. and Fischer, S. (1991), “Moderate Inflation”, NBER Working Paper N°3896, Cambridge.

under strong pressure to ward off the ghost of deflation, given that its perverse and systematic effects are only too well-known, even though they have been little more than a mere curiosity, a footnote in textbooks, since the gold standard era.

Without denying the fact that inflation levels are especially low, it is worth being a little cautious regarding the economic policy implications that this entails, partly because we could be confusing deflation with a change in absolute price levels. The drop in raw material prices has been highly significant, especially that of oil and other energy sources, which have fallen by more than half over the last year. Furthermore, there are strong supply- and demand-side reasons pertaining to oil that seem to indicate that we are witnessing a permanent, or at least long-lasting, change. The technological revolution on the supply side, energy efficiency in terms of consumption and growing environmental pressure all help to explain this structural change. According to the Studies Department at Repsol, oil accounts directly for 10% of the CPI figure and indirectly for almost 50%. It is possible that once the knock-on effect on absolute price levels and brusque changes in relative prices according to the energy intensity of goods and services, have played themselves out, inflation could once again become a problem. Furthermore, it is somewhat paradoxical that falling energy prices should have led to a deflationary effect in consuming countries, given that they are now benefitting from an income that was previously passed on to producers and that can now be devoted to consumption.

In addition, the causes of excessively low inflation are not that evident. And not all of them would necessarily lead to expansionary monetary policies. What if, in addition to monetary and credit expansion, inflation should require wage pressures? The relationship between wages and inflation (the Phillips Curve) has become much more tenuous in view of the recent deregulation of the European labour market and the loss of trade union negotiating power due to the effects of globalisation and the outsourcing and digitalisation of Europe's economies[8]. If this is the case, low inflation in the developed countries has more to do with the structural adjustments that the labour markets have made to globalisation – which is to say, with a tendency for wages to match productivity in open economies – than with monetary policy. Flooding the market with liquidity would not generate inflation, but it would distort the way savings operate and distort the financial system.

It is also possible that the demographic structure has something to do with low inflation in Europe. But not in the way that the secular stagnation hypothesis claims, by depressing interest rates. Quite the contrary. What if negative interest rates actually accelerate deflation within an ageing economy full of rentiers? If the

[8] Artus, P. (2016), The Two Obstacles Between Quantitative Easing and Inflation in the Eurozone, Natixis Research.

performance of savings is an important source of income available to consumers, consumption positively depends on how much savings generate. In these circumstances, lowering interest rates to levels close to zero will only hold back consumption further and prolong the threat of deflation[9].

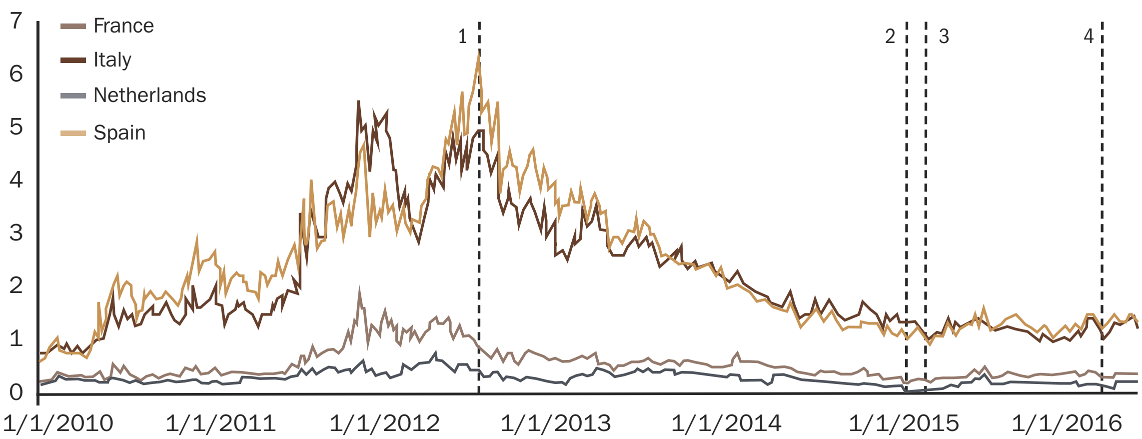
III. Reducing Financial Fragmentation in the Eurozone

In Europe's case, monetary policy becomes even more complicated due to the need to consolidate a still fragile and imperfect monetary union. In simple terms, when the ECB decides to intervene in the market by purchasing public debt, it not only has to decide how much to buy and for how long, like the FED or any other normal central bank, but also what national role it acquires, given that there is no European asset that is free of risk with which to lead monetary intervention operations. It is the ECB's obligation to consolidate monetary union and avoid the financial fragmentation of the Eurozone. This is where the famous "whatever it takes" commitment comes from.

The ECB's policy has undoubtedly been successful in terms of reducing fragmentation of all of Europe's financial markets, as can be observed in Graph 8, which refers to the government bonds spread, and in Graph 9, which refers to the private credit markets. However, it has not be able to recover the integration lev-

GRAPH 8.

Ten-year government bond spreads against Germany (%)



Source: Demertzis and Wolff, *The effectiveness of the ECB's asset purchase programme*, Bruegel Policy Contribution, 2016/10
Notes: 1) "whaever it takes" ; 2) PSPP announcement; 3) Start of PSPP; 4) CSPP and expansion of PSPP. See notes to Figure 2.

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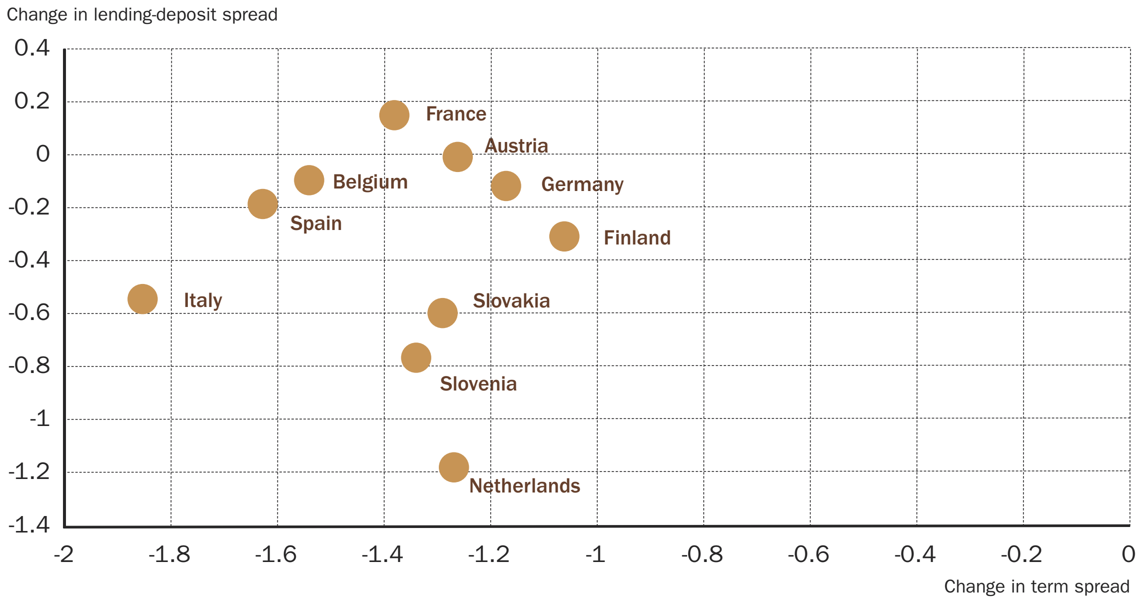
9 It must be true that poor ideas never die, because this argument already occurred to me many years ago when studying the case of Japan. See Fernando Fernández (1998), "El problema de Japón", *Revista del Instituto de Estudios Económicos* Nº4, Madrid.

GRAPH 9.

Changes in the term spread and the lending-deposit spread between January 2014 and April 2016 (%)



Fuente: Papadia and Wolf (2016), *Central Banks from omnipotence to impotence*, Bruegel Blog, March 2

els witnessed prior to the crisis[10], in which respect you could state that, in this sense, the scars have been permanent. This is to the extent in which a certain country risk has reappeared in the Eurozone, one that is magnified every time doubts emerge regarding Europe's commitment to progressing with the mutualisation of banking and sovereign debt.

However, the central question when it comes to assessing the efficacy of current monetary policy is whether this relative success is due to zero interest rates or to advances in the banking union process. And the very least we can say is that there are serious reasons to believe, in both a theoretical and empirical sense, that financial integration depends more on the irreversibility of the monetary union process than on any specific monetary policy stance. Internal capital flows do not vary according to the degree of monetary expansion in integrated and consolidated financial markets such as those of the United States or China. Although it is also true that, as in domestic credit markets, the size of credit spreads positively depends on the specific level of the reference rate. In short, in spite of the success of the ECB's declarations and the opportune policy assertiveness of some of its measures, I sincerely believe that the

[10] Díez, J.R. (2016), "Evolución de la fragmentación financiera en el año 2015", *Anuario del Euro 2015*, Fundación de Estudios Financieros and Fundación ICO, Madrid.

“The only thing that remains for the ECB to try is purchasing private equity on the secondary market, as Japan and Hong Kong have done in times of recession and possible deflation”

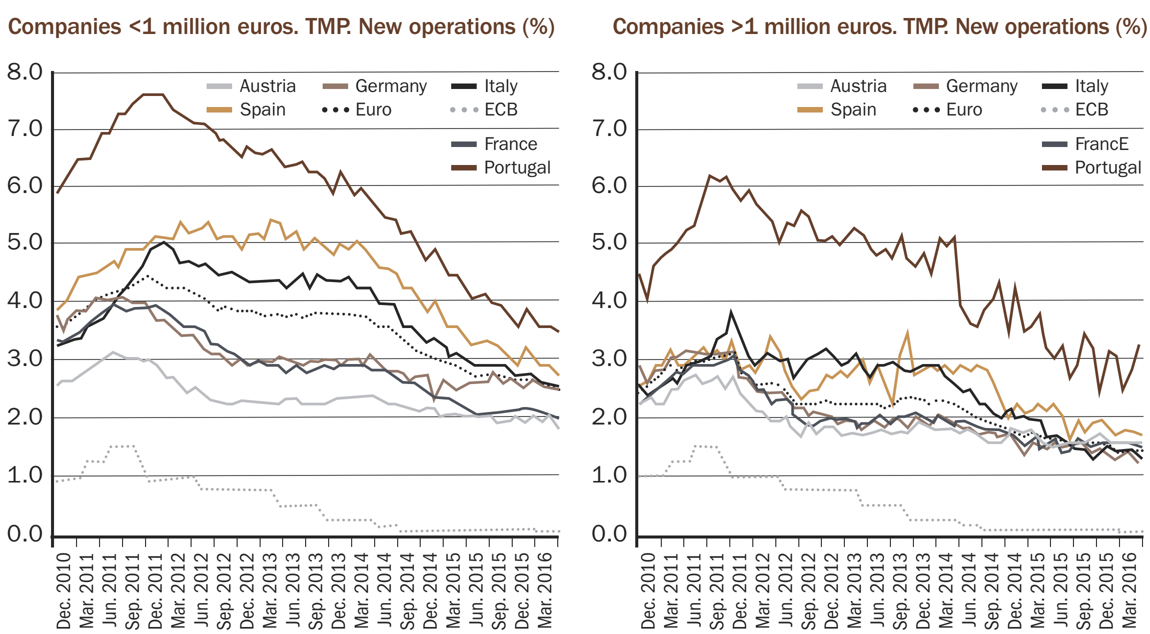
credit for reducing financial fragmentation lies with Europe’s much-maligned politicians, without whose commitment banking union would not be a reality today.

IV. Facilitating the Access of SME’s to Credit

Another of the arguments that tends to be offered when it comes to explaining the success of non-conventional monetary policies consists of the idea that Europe’s small and medium-sized enterprises have recovered their access to credit. As can be observed in Graph 10, there is no doubt that the ECB’s measures have made it cheaper for SME’s to gain access to credit in all of the EMU countries and, more importantly still, that they have reduced the cost differentials according to country. These have ceased to be significant for new operations of more than one million euros, with the sole exception of Portugal, and they are not especially significant for operations of a smaller size that are typical amongst SME’s. In fact, according to the latest figures available, the cost of credit and access to credit have ceased to be restrictive factors regarding investment in the case of Spanish SME’s.

GRAPH 10.

Cost of Credit According to Country and Size of Company



Source: ECB, Interest Rates Report July 2016 and Estudios Bankia

"The secular stagnation hypothesis is frequently used to justify especially low capital yields. If productivity is low, then capital yields and natural rates of interest are also low"

However, the relevant question for the purposes of this article, and adding to our previous considerations regarding the degree of fragmentation in the Eurozone, is whether there has been (or continues to be) a problem in terms of lack of credit within the private sector in Europe's economies, a debate that is extremely familiar in Spanish society and that played a significant role in the restructuring of the banking sector. Was there no credit because the banks were restricting it or because the deteriorating economic outlook had significantly reduced the levels of reasonable credit and the number and quality of credit beneficiaries? Furthermore, if restrictions regarding access to credit did exist, was this a problem of price or simply a matter of the quality of the banks' balance sheets?

Because we cannot ignore the fact that, after a debt crisis such as that which affected Spain and Europe, a reduction in overall credit levels is not only to be expected, but actually desirable. This is unless we consider the pre-crisis levels to be reasonable and sustainable and deny the fact that a credit bubble existed. And all this is irrespective of the opportune nature and convenience of the BCE's policy. We are once again faced with a different approach to the problem of diagnosing the financial crisis, a theme that pervades this article from beginning to end.

V. A Prior Step Required for the Introduction of Even More Extraordinary Measures: Helicopter Money

Let us start by defining the concept of 'helicopter money', a term that has become extremely popular in recent months. This is an old expression coined by Milton Friedman that is really quite simple. In short, it consists of a permanent fiscal stimulus, one that is consequently not subject to the objection of *Ricardian equivalence*[11]. This fiscal stimulus can take the form of public spending, tax reductions or direct payments to individuals. In fact, quantitative easing (QE) programmes would constitute a form of helicopter money (HM) if central banks were to maintain public bonds for perpetuity, something that has not yet happened, and pass on interest charges and amortisations to the Treasury, as, in fact, they already do with any profits. In its crudest version, creating 'helicopter money' comes down to hand-

[11] According to this theorem, tax-payers, who are fully informed and conscious of their actions, anticipate the fact that any public spending programme will necessarily result in higher taxes and, therefore, less disposable income in the future. In this respect, they neutralise any easing effect intended by this public spending with more private saving and lower consumption. The exact amount of this equivalence is a question of academic debate.

ing out cash to the population in a more or less indiscriminate manner[12]. However, things are a little more complicated when we take into account the detail and the institutional and distributive complexities.

For some economists, what are known as the New Keynesians, the only obstacle to HM in Europe is political: the fact that the ECB is expressly prohibited from financing governments directly. In this sense, we would need to remove this unnecessary legal restriction as soon as possible, which is not at all easy, given that it would mean amending the Maastricht Treaty[13]. Amongst those who are active proponents of this kind of monetary financing of public deficits in special situations such as those we are currently witnessing, we might mention Adair Turner, William Buiter and Jordi Gali.

For other economists, whom we shall call the eclectics, and which includes Bernanke himself, HM can work in deflationary situations, even when every other policy has failed and even when the country is seriously in debt, this being considered to be one of the traditional objections to this policy. Nevertheless, this does not cease to be an intertemporal redistribution of the burden of a perpetual debt. However, the real problem relates to implementation and the estimation and calculation of its redistributive impact. It is, in short, a problem of political economics: whose current account should be credited with the money, how much money should be paid and how should it be paid? These are not easy questions and some different solutions have been proposed, ranging from using the current personal income tax system as a kind of band-based fiscal credit system, to direct transfers to the taxpayers' current accounts. The problem is not only to avoid the social exclusion of certain groups, those outside the banking system, or to consolidate the redistributive social preferences enshrined in the personal income tax system. The central question regarding the efficacy of HM is the marginal propensity of different social groups to consume, which would lead to some difficult ethical questions, such as the idea of giving priority to young couples with children. All of these aspects may seem marginal or simply designed for the entertainment of economists, but they highlight a key idea that is normally absent in the academic debate: the implementation of an HM policy cannot be left solely in the hands of central bank specialists, given that it can have important fiscal consequences. This logic is even more relevant in the case of the ECB, due to the institutional characteristics of the Eurozone and the peculiarities of its incomplete fiscal union.

Finally, it is worth remembering that for traditional monetarists, the risk of inflation, that is to say, the idea that money loses its value, continues to be a real-

[12] Bernanke, B., "What Tools Does the Fed Have Left? Part 3: Helicopter Money", Brookings Blogs, 11-4-2016.

[13] And, I fear, it would mean changing the German mentality that lies behind this restriction. And doing so for a debatable cause in terms of its efficacy and opportune nature.

ity that rises exponentially with HM policies. This reality seems rather unlikely today because, as we have already stated, we are facing an energy price shock that has profoundly changed relative prices[14].

2.2. A Description of the Transmission Mechanisms of an Expansionary Monetary Policy

One of the best summaries of how a heterodox monetary policy based on quantitative easing can exert an impact can be found in Demertzis and Wolff (2016)[15]. These authors highlight four channels of implementation, which are described below:

1. By purchasing government bonds and reducing normal long-term interest rates, central banks encourage investors to buy more risky assets. In this respect, it is evident that the central banks have managed to reduce long-term interest rates to an all-time low. Thus, for example, the Spanish 10-year bond has fallen below 1% for the first time. However, the idea that this has awoken investors' appetite for risk is somewhat debatable, given that what we are witnessing on the markets at present is investors flocking towards quality, towards safe-haven assets, which has brought down yields to negative levels. Either that or investors have anticipated a long and serious recession and have become prepared to do anything – even pay good money – to save their assets.

2. Low interest rates encourage consumers to boost their consumption levels, bringing their life plans forward and reducing saving. This effectively increases demand and levels of employment, as well as raising prices in the face of rigid supply and idle capacity. This will always be the case provided that the price effect predominates over the wealth effect, because very low interest rates force consumers to save harder in order to maintain their future income. Demography and the distribution of the population according to age groups have proven to be essential when it comes to calibrating the impact of this transmission channel in ageing and rentier-based societies such as those of Europe.

3. Investors also bring their investment decisions forward in view of the fact that financing has become cheaper. The impact of this transmission channel brings us back to Say's Law[16] and the old debate regarding the elasticity of investment

[14] A reality that explains why the latest data relating to the Eurozone show a difference between the headline inflation rate and core inflation rate of almost one percentage point.

[15] Demertzis, M. y Wolff, G. (2016), The Effectiveness of the European Central Bank's Asset Purchase Programme, Bruegel Policy Contribution.

[16] Made by Jean-Baptiste Say (1767-1832), Say's Law is an economic principle that all supply creates its own demand. That is, the production of goods of an economy generates enough revenue to create a demand equivalent to the same production.

“Inflation within the Eurozone is at an extraordinarily low level, with the harmonised rate standing close to 0% since 2015 and underlying inflation coming to below 1%”

regarding cost, the interest rate, and/or final demand. It also recalls the speculative motive for the Keynesian demand for money versus the classic investment accelerator hypothesis. During periods of uncertainty, when some investors are concerned about the health of the financial system, accompanied by significant geopolitical dangers and doubts regarding the ongoing progress of globalisation in the face of proliferating protectionist threats[17], it is possible that investors will continue to harbour serious doubts regarding the size and strength of final demand, however cheap money may be.

4. By increasing liquidity, and should interventions not be sterilised, QE policies effectively weaken the exchange rate and facilitate economic recovery by means of exports. Irrespective of the global inconsistency of a policy of this kind, for which the United States has been harshly criticized by up-and-coming economies and multilateral institutions, the question in Europa is whether the EMU has a balance of payments problem or simply a problem regarding the internal distribution of surpluses, which is to say, the internal distribution of savings and investment. It would seem difficult to argue the former case in the Eurozone, with continual and growing foreign trade surpluses, structurally fuelled by its energy dependency when oil prices are low. Although it is not that relevant to this article, this would lead us to consider whether it is reasonable to set limits on the export capacity of certain countries in order to facilitate the adjustments that must be made by less competitive countries, as stipulated by the Macroeconomic Imbalances Procedure. Would it not be more useful to study how we might accelerate competitiveness reforms in those countries that are lagging behind?

In short, the theoretical channels through which a quantitative easing policy operates are as follows:

a). The performance of government bonds;
b). Boosting credit, especially for SME’s if the QE policy is properly “focused” (the justification of TLTRO),
c). The exchange rate, which raises problems of international coordination;
d). The redirecting of investors’ portfolios towards riskier assets.

[17] The latest, the practical elimination of the free trade treaty between the United States and Europe, known as the Transatlantic Trade and Investment Partnership (TTIP), in view of the fact that Europe’s doubts have been exacerbated by the fact that the two candidates for the US presidency have publicly declared their opposition to same.

"It is the ECB's obligation to consolidate monetary union and avoid the financial fragmentation of the Eurozone. This is where the famous 'whatever it takes' commitment comes from"

2.3. Attempts to Measure the Effects of QE and Zero Interest Rates

Having established the mechanisms through which a non-conventional monetary policy might be implemented, the next step is to attempt to measure its effects and calculate its potential impact under the conditions that exist within the European economy. In the words of Mario Draghi, event studies carried out by the ECB show that the central bank's measures have had a strong impact on the performance of long-term government bonds, an effect that has also been reflected in the performance of corporate fixed-rate bonds. The quantitative easing policy implemented by Europe's monetary authority has also directly affected the price of bank credit, reducing it significantly, whilst also indirectly affecting credit conditions[18]. These impacts have been recorded and quantified in numerous studies whilst coinciding in time with the adoption of asset purchase programmes. Another thing all together, however, is establishing a causal link, as we shall see.

As far as Spain is concerned, and as the Governor of the Bank of Spain has recently declared, it is estimated that the monetary measures package implemented by the European Central Bank has had an accumulative effect of 1.2 percentage points in terms of raising the country's GDP figure throughout the two-year period encompassing 2015 and 2016 and 0.9 percentage points regarding Spanish price levels. These impacts are slightly lower than those achieved throughout the entire Eurozone (1.4 points for GDP and 1.1 points for the CPI)[19].

The Bank of Spain's Annual Report also analyses the heterogeneous effects of these monetary policy measures and observes that they have led to a relaxation of the prevailing financial conditions, which has been greater in the peripheral countries than in the "central" States. Thus, for example, as measured in terms of interest rates on 10-year debt, the Bank of Spain attributes an impact of 35 b.p. in the case of Germany, compared to 140 b.p. in the case of Spain and Italy, which would seem to confirm the fact that QE assures the market and serves as a guarantee for buyers. And all this in spite of the rigid purchase rules scrupulously followed by the ECB and the fact that the central bank somehow correlates the magnitude of its intervention with public bonds with the size of the national GDP.

[18] Altavilla, C., Carboni, G. and Motto, R. (2015), *Asset Purchase Programmes and Financial Markets: Lessons from the Euro Area*, ECB Working Paper Nº1864.

[19] Anuario del Banco de España 2015, *El efecto de las políticas monetarias del BCE en el pasado reciente*.

Nevertheless, this larger impact on interest rates has not led to a greater impact on growth and inflation. Quite the contrary, in fact, as we have just seen. The reason may lie in what are known as market access problems, in the existence of bottlenecks in the transmission mechanisms during the crisis in those countries subject to financial pressures. In the last instance, these access difficulties are justified with higher debt levels, more fragile banking systems and the fragmentation of the financial system itself within the Eurozone. In my opinion, the lesson to be learned from these events, using a term coined in the literature that focuses on crises in up-and-coming countries, is that non-conventional measures have helped to prevent financing cost problems, but have done little to address episodes of 'capital drought', because the latter reflect errors and imperfections in the design of Europe's Monetary Union.

The quantitative results are not all together conclusive and various studies produced by non-official bodies have obtained somewhat different results. In this respect, according to these studies[20] Germany is the country that has benefitted the most from QE in terms of the increase in the core inflation rate, whilst Spain has benefitted the most in terms of GDP growth. The former is a question of market size, whilst the latter is due to the restructuring of the financial system and the fact that Spanish families are the most heavily indebted at Euribor-indexed short-term variable rates and, therefore, are the ones who have experienced the greatest debt relief, thus being able to devote a larger portion of their disposable income to increasing consumption. Curiously, this sensitivity to interest rates presents a very different picture from the point of view of the financial margins of banking institutions, as we shall see below when we deal with regulatory policy and the results of the stress tests that have been carried out.

A very different evaluation is offered by the BIS. In the words of its Director of Research, Claudio Borio, "there is ample evidence that, to varying degrees, the unconventional measures of central banks have succeeded in influencing financial conditions, even though their ultimate impact on output and inflation is harder to pin down; the balance of the benefits and costs is likely to deteriorate over time and the measures are generally best regarded as exceptional, for use in very spe-

"For what are known as 'New Keynesians', the only obstacle to HM in Europe is political: the fact that the ECB is expressly prohibited from financing governments directly"

[20] Barclays Research, 2016, op. cit., which also highlights the fact that this easing effect has undoubtedly been boosted by the restructuring of the Spanish banking system.

cific circumstances. Whether this will turn out to be the case, however, is doubtful at best[21]". The BIS, which departs from a very different diagnosis of the crisis as a question of over-indebtedness and not a lack of demand, is also much more sceptical about the effects of non-conventional policies.

Basically this is because we cannot prove a causal link and because it highlights the presence of some highly negative collateral effects that the studies produced by national and European monetary authorities do not tend to take into consideration, or at least do not take sufficiently into account. In effect, the problem with all the previous estimates regarding the effects of non-conventional monetary policies is that, in spite of the econometric techniques employed, it is very difficult or virtually impossible to carry out a counterfactual analysis in the changing economic conditions of the European Monetary Union, one that is being subjected to profound institutional changes. How much might the Eurozone have grown simply with the effect of the oil price terms of trade and the progress made regarding the banking union after the *whatever it takes* declaration? How much growth might there have been if definitive progress had been made with the mutualisation of bank debt with an integrated Deposit Guarantee Scheme and a credible Resolution Mechanism featuring its own debt capacity? How much if there had been a credible fiscal backstop, based on a fiscal union with a shared Treasury, a European asset free of risk and endowed with centralised economic stabilisation powers? What is more, these institutional advances towards the normalisation of the Eurozone would have avoided any perverse collateral damage to the financial system and the money multiplier.

2.4. Main Risks of an Unlimited and Persistent Expansionary Monetary Policy

The Governor of the Bank of Spain has recognised the "potential undesired collateral effects"[22] that the ECB's non-conventional policies might have regarding financial stability, such as the overvaluation of certain assets and downward pressure on the profitability of the banking sector. In this respect, Luis María Linde

"For eclectic economists, liquidity expansion policies can work in deflationary situations, even when every other policy has failed and the country is seriously in debt"

[21] Borio, C. and Zabai, A. (2016), Unconventional Monetary Policies: A Re-appraisal, BIS Working Paper Nº 570, Monetary and Economic Department.

[22] "Linde cifra en 1,4 puntos del PIB el efecto en España de la política monetaria del BCE", *Expansión*, 6-7-2016.

"For traditional monetarists, the risk of inflation, that is the idea that money loses its value, continues to be a reality that rises exponentially with HM policies"

has recently declared that it is important to ensure specific monitoring of the segments at risk, implementing macro-prudential measures if necessary. This declaration would appear to be a good starting-point when it comes to questioning the importance and intensity of these collateral effects.

These perverse effects reside precisely in the fragile permanence of non-conventional policies, as highlighted by leading analysts. The first problem, which is significant in the case of QE, is that we are dealing with a mistaken diagnosis, which is to say that, in spite of the statements made by the ECB and the IMF, we are not witnessing so much a crisis of demand – against which we must activate all management levers in order to ensure fiscal and monetary expansion –, as a balance-sheet crisis[23], as the BIS has systematically argued and as can be observed in Graph 7 mentioned above. It is not so much a question of world demand having been structurally affected, more a question of it having moved to other parts of the world. We are dealing rather with a crisis of globalisation, a direct consequence of what in Asia they call "the end of Western exceptionalism". Within this scenario, conventional demand policies are not and cannot be effective.

The corollary of this type of balance-sheet crisis, this excess indebtedness, is that periods of 'irrational exuberance', to use Greenspan's forgotten phrase, leave inevitable and long-lasting scars on the real economy. In this respect, Mario Draghi's declaration that non-conventional policies are particularly effective in periods of uncertainty and financial fragmentation certainly grabs the attention[24].

It is an established fact that an exceptionally low interest rate policy represents a form of financial repression, a means of transferring the cost of a crisis to savers, a sophisticated way of restructuring debt in a silent and concealed manner, something similar to a readjustment or re-adaptation in order to prevent default. This is one of the traditional mechanisms for tackling a debt crisis, one that is especially

[23] Caruana, J. (2014), Stepping out of the Shadow of the Crisis: *Three Transitions for the World Economy*, opening speech at the Annual Assembly of the Bank for International Settlements, Basel.

[24] Draghi, N. (2016), "unconventional monetary policy can be effective in any circumstances, but particularly so when risk premia have risen due to market fragmentation or unwarranted uncertainties", *Delivering a Symmetric Mandate with Asymmetric Tools: Monetary Policy in a Context of Low Interest Rates*, speech delivered to mark the celebration of the 200th Anniversary of the Oesterreichische Nationalbank, Vienna.

"The quantitative easing policy has also directly affected the price of bank credit, reducing it significantly, whilst also indirectly affecting credit conditions"

useful in the case of fixed exchange rates[25]. However, it is also well-known, and highlighted by the same authors in their original article, that financial repression creates even more distortions with regard to the efficient allocation of resources, because it effectively entails an inefficient allocation and the loss of the risk-profitability factor as the criterion for investment. Because, over and above the initial relief, is it reasonable that 50-year Swiss debt should exist at negative rates? Is it reasonable that Germany's 10-year bonds should be offered at negative rates or that companies from IBEX-35 should be acquiring resources at rates close to zero? If that is the case, then these companies could increase their debt levels indefinitely. The way the markets are behaving at present, it appears that bond-holders are saying 'yes', but this is not the opinion of analysts, who are punishing the stocks of companies that they consider to be excessively in debt, in spite of the fact that the current cost is minimal and easily borne.

Furthermore, and irrespective of the fact that the secular stagnation hypothesis does not justify considering interest rates close to zero as a form of equilibrium, perhaps this stagnation has less remote causes, given that periods of credit explosion tend to undermine output growth given that factors of production are displaced towards less productive or competitive sectors. By acting in this way, like a kind of Dutch disease, they generate bubbles of growth featuring low productivity that end up bursting, as certain Southern European countries have discovered and as many up-and-coming economies well know. The problem is that financial repression unnecessarily extends the adjustment process[26] by lowering the cost of maintaining excess debt and sustaining the poor allocation of resources.

Non-conventional polices have a foreseeably adverse effect on the desire for reform. As pointed out by the OECD in its last report, what is called the 'reform momentum' has clearly decreased in Europe, especially in those countries that have benefitted most from this monetary policy by having participated in the Troika's rescue programmes[27]. This should not surprise us and it is not necessary to attribute either to complex economic policy phenomena such as 'adjustment fatigue'. It is due to something much more classic and traditional, namely

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[25] Reinhart and Rogoff (2009). "The aftermath of financial crisis", NBER Working Paper nº. 14656

[26] Fernández, F. (2015), *El BCE y los límites de la política monetaria*, ICE Nº883.

[27] OECD, *Economic Policy Reforms: Going for Growth*, 2015.

monetary illusion. If debt is sustainable and it is not difficult to maintain it, why reduce it? As might be expected, populist movements spring up calling for additional increases in public debt and attesting to the innocuous nature of non-payment phenomena.

It is evident that, by ensuring a buyer and offering a *de facto* guarantee regarding the minimum cost of sovereign bonds, the ECB's public asset purchase programme has removed any pressure that might lead to fiscal consolidation. This political relief is complemented by calls to reconsider the fiscal momentum and the fiscal rules of the Monetary Union itself. Allow me to say a few words about a key theme that is not subject to debate in this article, but which undoubtedly has a bearing on the debates regarding non-conventional policies. It would appear more rational, and less distortional, that if the fiscal rules were considered to be poorly designed[28], we should proceed to change them. But it is not especially reassuring that monetary policy should be used to compensate for fiscal design defects, or that voices should call to ignore or breach them in view of the political impossibility of changing them, because they constitute the hard core of the social agreement around which the Monetary Union revolves.

Furthermore, if the objective is for the EMU to implement an expansionary fiscal policy as a Union, because the overall consolidated fiscal position is considered to be convenient and based on a sufficient margin, it would be a question of endowing the Eurozone with a Stabilisation Fund and/or turning the European Stability Mechanism into an embryonic European Treasury. However, this objective does not justify using monetary policy as a hidden fiscal instrument, given that it simply undermines the credibility of EMU and the solvency of the financial system even further.

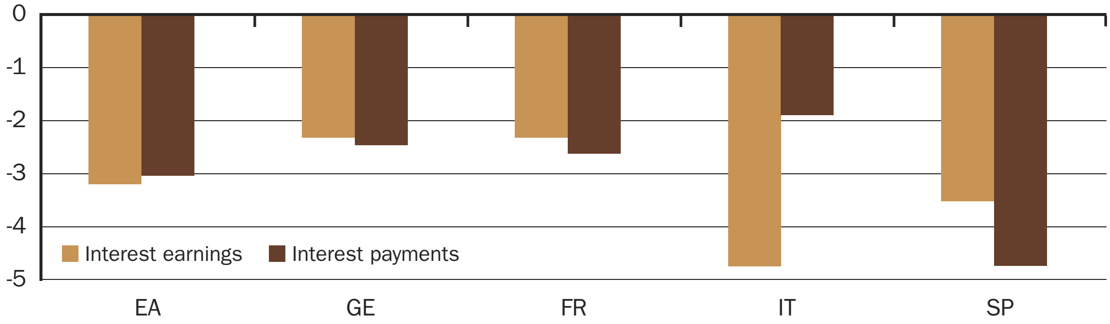
A financial repression policy constitutes a means of subsidising debt and silently transferring the benefits of savers to debtors. If in any single country this is always a controversial policy, in the Eurozone it is evident that this must necessarily have additional geographical and political connotations. The rise of certain

"Non-conventional measures have helped to prevent financing cost problems, but have done little to address episodes of 'capital drought', the result of errors and imperfections in the design of Europe's Monetary Union"

[28] This is not the place to discuss Europe's fiscal governance, but readers who are interested can refer to the Euro Yearbook 2015, which tackles this central issue regarding the sustainability of the Eurozone in great depth.

GRAPH 11.

Households' interest payments/earnings Q3 2008-Q4 2015 (changes as a percentage of gross disposable income, percentage points)



Source: ECB, Economic Bulletin, Issue 4/2016, Box 3

ultra-nationalistic movements is not unrelated to these sensibilities, although the facts are not as evident as some populists would have us believe, to the extent that they depend strongly on the wealth structure of families and cultures, as well as on saving practices. Thus, to the surprises of many demagogues, Italy is one of the countries most affected by the financial repression, given that its prominent families are large holders of bank assets (deposits or senior debt)[29], as can be observed in Graph 11. Spain, however, is a strong beneficiary of this policy, given that families' interest payments on their loans are higher than their income from bank deposit savings.

Nevertheless, there is little doubt that the maintenance of this punishment regarding savers over time places the long-term stability of the EMU – and even its very survival – in danger. Germany's full-frontal opposition to QE in this respect is fully justified, although its net effect is not so obvious in the graph above. The fact is that even the main proponents of monetary union in Germany, such as Deustche Bank itself, are becoming increasingly critical after seven years of non-conventional policies that threaten the long-term stability of the Eurozone[30]. Ignoring these critical voices and the economic foundations on which their opinions are based would constitute a case of unforgiveable political and economic short-sightedness, given that it would be tantamount to ignoring the constitutional pact that gave rise to the euro.

[29] ECB, *Low Interest Rates and Households' Net Interest Income*, Economic Bulletin, Issue 4/2016, Box 3.

[30] Folkerts-Landau, D. (2016), "After seven years of ever-looser monetary policy there is increasing evidence that following the current dogma, broad-based quantitative easing and negative interest rates, risks the long-term stability of the Eurozone", in *The ECB Must Change Course*, dbStandpunkt, Deutsche Bank Research. This study crudely summarises not only the stance of many German economists, but also that of a large part of its financial community and the country's policy-makers.

“The first problem with quantitative easing is that we are dealing with a mistaken diagnosis, which is to say that we are not witnessing so much a crisis of demand as a balance-sheet crisis”

Neither should we ignore the negative effects that non-conventional policies have on profitability and the solvency of the financial system, although it is true that, to the extent in which it has helped us to recover economic growth and employment, monetary policy has managed to improve the health of bank debtors and, consequently, bank balance-sheets, by reducing non-performing loan ratios. But maybe its effects have now been exhausted or could have been achieved with less aggressive and pro-cyclical regulatory policies, as we shall see later on. Furthermore, should these non-conventional policies be applied for too long, they could cause long-lasting damage within the financial sector[31]. Specifically, within a scenario in which interest rates are close to zero: (i) the search for yields, minimal though they may be, leads to higher levels of risk and may give rise to asset bubbles in certain markets[32]; (ii) the profitability of financial institutions is damaged, making maturity transformation less profitable, a core business at any bank; (iii) it allows weaker banks to distribute profits to their shareholders instead of retaining them in order to make up for insufficient capital levels[33], which leads to undesired opportunities for regulatory arbitration; (iv) and it accelerates banking disintermediation, with the consequent risks for customers and for taxpayers, in the sense that this only responds to regulatory or political incentives and not to the natural movements of institutions and financial product consumers.

In short, as highlighted by the IMF in a recent report, the zero or negative interest rate policy has an adverse effect on banks’ profitability. A point is reached in which the negative effect of interest rates on margins “surpasses the profits that derive from high asset valuations and the strength of aggregate demand[34]”. The Eurozone may have reached this point already and it is worth considering the exit options and studying alternative strategies that might stimulate economic growth and consolidate monetary union.

[31] BaFin President (2016), *Low Interest Rates Put Strain on Financial Sector*, BaFin.

[32] A good example of these bubbles is provided by the sale of LinkedIn for US$23 billion, in spite of the fact that it has never generated a positive cash flow.

[33] Song Shin, H. (2016), *Bank Capital and Monetary Transmission*, BIS.

[34] Jobst (2016), “Negative Interest Rates Policy (NIRP): Implications for Monetary Transmission and Bank Profitability in the Euro Area”, IMF WP16/172.

The ECB publicly counters these criticisms by pointing out that its remit does not include the objective of defending the margins or profitability of the banking sector and that, whatever the case may be, this vulnerability is not generalised, but depends rather on the structures and practices of the national banks, an argument that does not seem to convince bank analysts and investors, especially those in Europe, judging by the banks' stock market performance (Graph 2). However, it is true that the vulnerability of the different national banking systems to zero interest rates is neither linear nor homogeneous, depending, according to the International Monetary Fund[35], on:

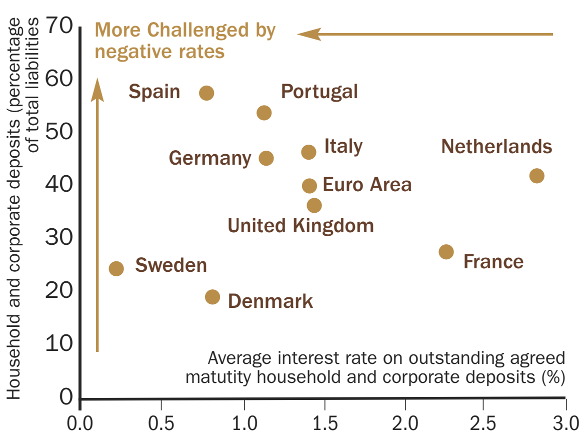
1. The sensitivity of assets and liabilities to zero interest rates (Graph 12), benefitting those systems that are most rigid or most opaque when it comes to passing on the prevailing conditions in the wholesale markets to bank customers.

2. The capacity to generate alternative revenue other than the financial margin. The IMF highlights the potential to charge for services rendered, an increase in commissions, which seems to suggest a veiled preference for a bank model in the form of a kind of regulated public service, a utility.

GRAPH 12.

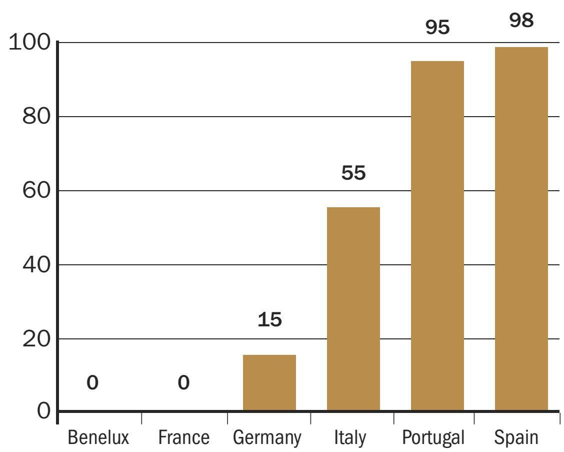
Continued low rates could bring pressure on other financial institutions...

Household and Corporate Deposits as a Share of Total Monetary Financial Institution Liabilities and Interest Rates on Outstandings Agreed Maturity Deposits, January 2016



Banks with a large proportion of mortgages priced to reference rates cannot raise mortgage rates...

Tracker Mortgage Loans (Percent of total mortgages)



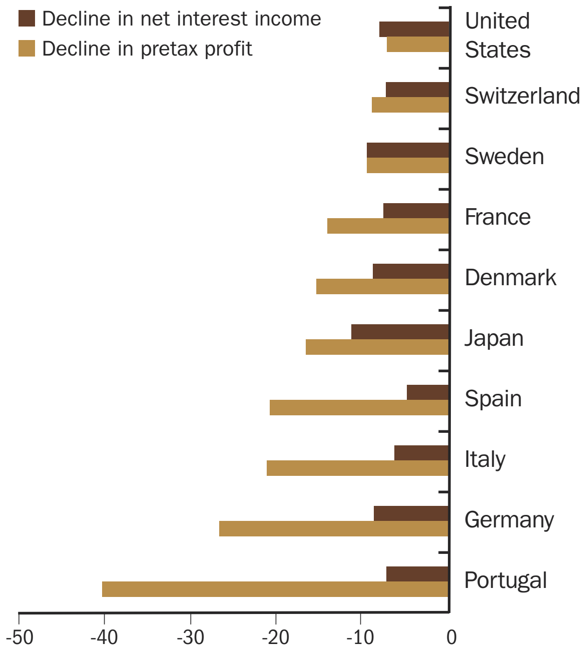
Source: IMF, *Global Financial Stability Report*, April 2016

[35] IMF, *Global Financial Stability Report*, April 2016.

GRAPH 13.

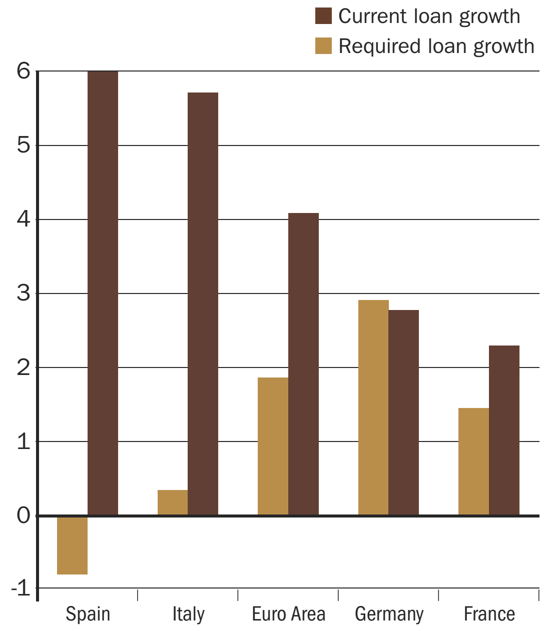
Declining net interest margins will hit profits of European banks more strongly

Impact of a 10-Basis-Point Decline in Net Interest Margin (Percent)



Substantial loan growth wold be required to make up loss of net interest income

Euro Area: Annual Loan Growth Required to Offset Decline in Current Net Interest Margin, End-2015 (Year-over-year percent change)



Source: IMF, *Global Financial Stability Report,* April 2016

3. The intermediation margins to begin with (Graph 13). This makes reference to systems such as that of Spain, where loans, even mortgage loans, are overwhelmingly indexed in the short term and where financing is highly dependent on retail deposits. For its part, this last aspect would seem to flagrantly contradict the lessons of the crisis, given that retail financing via deposits has always been one of the strengths of traditional retail banks.

4. The business model of each bank, a highly recurrent theme in both the academic world and amongst central bank specialists, to the extent in which the Single Supervisory Mechanism (SSM) has made this one of the main planks of its regulatory approach, one known as the *Supervisory Review and Evaluation Process* (SREP) in banking jargon[36].

[36] Nouy, D. (2016) "Risks and Resilience - The European Banking Sector in 2016", speech delivered at the Bank Capital Forum, London.

"An exceptionally low interest rate policy represents a form of financial repression, a means of transferring the cost of a crisis to savers, and this ends up affecting banks' profitability"

The question of the banking business model deserves a brief digression, because this has become the mantra of all bank regulators, supervisors or mere analysts. Our first reflection is purely sceptical. It recalls rather too much politicians when they talk about models of economic growth and raises the old chestnut of politicians and regulators becoming businessmen and bankers. The empirical evidence regarding public-owned banks is quite conclusive, featuring some truly awful results and in Spain we have had a number of experiences of this kind in the recent past.

Whatever the case may be, it would be great if advocates of this approach were to clarify exactly what this new and more sustainable business model at zero rates actually is, because they might be thinking of a utility-type banking model, which would mean that financial institutions would charge a fee for the different services they provide. This fee would be fixed by the effective cost of these services and would require regulators to guarantee an attractive level of profitability for investors in the banking sector. This may seem attractive, but in practice it would mean going back centuries in banking history and returning to medieval models in which savers would pay to deposit their wealth in a safe and regulated asset (bank deposits) or would assume the market risks of depositing most of their wealth in non-guaranteed assets. It is not all together clear that, should savers be sophisticated and search for profitability over and above maintaining their capital, global financial stability would necessarily improve at all.[37]

Finally, we would need to ask ourselves whether the recent instability of the Italian banking sector has changed the majority view regarding the balance of risks of the zero rates policy, given that it would appear that many national regulators have continued to place their trust in growth in order to solve the problems of their banking sectors over time. However, the above-mentioned IMF report must have served to pour cold water on these hopes, given that the increase in credit required at zero rates must be extraordinarily strong in order to re-establish bank intermediation margins and make it possible to dilute the heavy portfolios of certain institutions.

[37] In fact, more or less extreme versions of pure banking, what is known as narrow banking in trade literature, were already debated and ruled out for very good reasons in the first regulatory reforms introduced after the crisis and these stances were defended during the debates surrounding the Dodd-Frank Law in the United States and the British Vickers Report.

3. Prudential Regulation

3.1. Basic Objectives

A financial regulation and supervision policy has been intensely used in the wake of the international financial crisis. In fact, this was expressly announced at the first G-20 meeting held to coordinate economic policies following the collapse of Lehman Brothers, and at times in 2008 when efforts were made to prevent what seemed like an inevitable recession turning into a great depression. Excessive deregulation is commonly cited as one of the causes of the crisis. Pointing the finger at liberalism as the dominant ideology that committed these errors is even more popular. However, the truth is that the financial sector has never been deregulated, whilst it would be quite unthinkable that this should ever be the case. What is more, these alleged errors of excessive liberalism occurred under the Clinton Administration in the United States, with Larry Summers as the leading economic policy ideologue, and under Social-Democratic governments in Europe.

It is truer to say that this alleged deregulation was brought about by the combined effects of a series of technical, technological and political advances that it would be difficult to see repeated. Amongst the first advances was the financial innovation that occurred following various key improvements in knowledge and that enabled players to place a price on uncertainty, thus permitting an explosion of increasingly complex secondary products. It is true that the finance sector enjoyed a kind of Renaissance during the late 1990's, a kind of fixation with mathematical and statistical models that measure everything. And this turned out to be a huge fiasco, because models can never be better than the data they are fed. We also witnessed some spectacular technological advances that led to an exponential increase in the speed of calculation and, even more importantly, made this cheaper and access to it more democratic, which meant that financial negotiation witnessed an astonishing upsurge. All this was accompanied by a series of unrepeatable political circumstances following the collapse of Communism as a feasible alternative and the rise of globalisation, which pulled millions of human beings out of misery and created a new global financial market and an unprecedented series of capital flows between different parts of the world. It is only too easy to forget these developments when blaming deregulation for all of the system's evils.

Whatever the case may be, the objectives of financial regulation have remained practically unchanged and they are fully accepted by all[38]. In fact, the specific policies they give rise to have led to a degree of regulatory activity that is probably excessive in recent years. The prime objective of regulation has always been the

[38] Davies, H. and Green, D (2009), *Global Financial Regulation: An Essential Guide*, Polity Press.

stability of the financial system itself, together with that of the economy. However, it is true that our interpretation has also changed quite substantially and, today, regulation is not only concerned with the stability of individual financial institutions – microprudential regulation – , but also, and above all, with the stability of the financial system itself – macroprudential regulation. It is precisely in the latter field that the greatest innovation has occurred and where the greatest amount of regulation has taken place after the crisis, to the extent of creating a number of completely new public institutions with this specific goal in mind, such as the European Systemic Risk Board. Nevertheless, perhaps the most important new development is our interpretation of the effects that the stability of the financial system can have on economic stability in general, with the consequent regulation in this respect. The costs of the crisis in terms of lost output and unemployment have been so high that they have become politically and socially unacceptable, giving rise to regulatory reactions that have not always been properly thought through[39].

The second traditional objective of financial regulation has always been to protect the retail customer. The self-evident asymmetrical nature of the information held by the respective contracting parties in the finance business is perfectly documented in all the classic manuals and certainly justifies this regulatory policy. It is also evident that the financial system committed some unforgiveable excesses during the boom period and today is a victim of its own reputation. We should not necessarily confuse these excesses with illegal or legally punishable acts, given that many errors of judgement clearly took place, even amongst many national and international regulators. And neither should we forget the fact that excess protection in economic policy very often works against the supposed protected party, as we are well aware in the labour market or in international trade[40]. The European Union's recent difficulties in passing the market directive known as MIFID 2, and the delay announced regarding its implementation due to a consultation with the industry, both provide ample proof of the problems inherent in such decisions, implications that go beyond a purely simplistic and presumably moral analysis.

The crisis has led to rising regulation and supervision in all financial jurisdictions based on institutional frameworks that are not always that clear and for which no

[39] Simultaneously demanding that financial institutions be more solvent and possess more and better capital, whilst providing more credit and taking more risks, and at a low-point in the economic cycle, seems to be a good example of this inconsistency.

[40] A certain judicial activism can aggravate the problem, since there is little doubt that some exemplary sentences that have been handed out, for example in Spain, relating to 'floor clauses' or the marketing of hybrid products, are difficult to justify, over and above the social indignation at banking excesses. Such developments have negative consequences on the mortgage market, the cost of credit and ease of access to housing, not to mention high-profit investment products. In this respect, see the marvellous preface by Manuel Conthe (2015), published previously in his blog, *El sueño de Jardiel,* under the suggestive title of "El Tour y las cláusulas suelo" ("The Tour and Floor Clauses").

“A banking model as a regulated public service, a utility, would mean that financial institutions would charge a fee for the different services they provide. In practice this would mean going back centuries in banking history”

internationally-agreed model exists. These frameworks range from instances of increased authority for the central bank to newly created institutions for monitoring conduct, based on what is known as the ‘twin peaks’ model. Other jurisdictions such as the Eurozone have created a two-level framework in which the supervision of financial conduct remains in the hands of the National Central Banks, thus maintaining the possibility of different practices and hidden protectionism.

With regard to the traditional objectives of regulatory policy mentioned above, the crisis has added another two goals: international coordination and the desire to avoid any cost to taxpayers and to society as a whole. International coordination is a necessary response to financial globalisation, to the increasing freedom of movement of capital and to specific resolution difficulties concerning certain institutions within the system where disagreements between regulators have lengthened the crisis and exacerbated its cost. The desire to avoid any cost for members of the public seems justified by the strong impact of the crisis, and this principle should imbue any kind of preventive regulation. However, it should not lead us to innocently presume that this is the last crisis that taxpayers will have to pay for, given that, by definition, in any systemic crisis of confidence in a fiduciary banking model, the ultimate guarantor cannot be any other than the State, with its coercive power to generate revenue through taxation.

3.2. A Personal Interpretation of the Current Regulatory Context

The purpose of this section is not to provide a comprehensive and systematic summary of the regulatory agenda imposed by the leading financial authorities following the crisis. Our aim is much more modest: to place some of these changes within the context of non-conventional monetary policies in order to explain the difficulties in coordinating both, since this appears to be a somewhat pending matter. In this respect, we shall begin by highlighting five aspects of the new regulatory framework that, despite some differences, have been put into practice in the leading monetary jurisdictions and, notably, within the European Monetary Union.

- **First,** if there is something that has characterised regulatory policy since 2008, it is the general conviction that financial institutions operate with capital levels that are clearly insufficient when it comes to facing solvency events. This problem is aggravated by the low quality of what is considered to be capital, given that many of the alleged capital instruments have proven to be non-existent

“More intrusive and discretional bank supervision necessarily requires greater transparency, higher predictability and a better system of accountability”

when it comes to covering the losses made by these institutions. The monetary authorities in the leading financial markets throughout the world have significantly increased the regulatory capital levels and have specified the range of instruments that can be used to fulfil this requirement. In spite of the draft international agreement known as Basel III, the truth is that the different jurisdictions have not been able to avoid national differences when it comes to enshrining these regulations in their respective national legislation. In Europe, CRDIV (*Capital Requirements Regulation and Directive*) and CRR (*Capital Requirements Regulation*) constitute the basic pieces of legislation that have been introduced.

The common denominator of all these new pieces of legislation is that they entail higher capital, liquidity and capital-quality requirements and lower levels of leverage. In this respect, although some voices still maintain that the new levels are insufficient[41], the fact is that they have led to an increase of almost 6 points regarding the levels required and, consequently, a reduction in the average levels of bank profitability and funds available for loans, as we illustrated in Graph 2 above. The macro-economic impact of this new and tougher bank regulation has provided ample cause for debate and the BIS, in its Annual Report 2015, defends the idea that the net effect could be positive, because of two mechanisms at work: (i) more capital entails a lower financing cost for the bank, which compensates for the higher cost associated with attracting more capital, and (ii) more capital means greater credit growth. This thesis seems to be at odds with the facts as they can be observed at present, which rather reflect the difficulties and rising costs that banks have had to bear that have turned to the market in order to raise their capital levels. Maybe this is a perfect example of monetary and regulatory policy contradictions, given that although it is true that a higher level of capital should give investors greater security and, thus, lower the cost of financing, it is also true that, in the current climate of negative interest rate policies, possible investors in banks envisage some very low levels of profitability and so demand very high prices when it comes to financing such institutions.

- **Second,** the methodology of regulating and supervising the banking system has evolved from the traditionally dual perspective of “fulfilling and intervening” towards a preventive model, one that permits supervisory institutions to impose

[41] The insistence of certain US academics and policy-makers in calling for capital levels of 20% is well-known.

restrictions on banks, precisely in order to make intervention unnecessary. Different capital cushions have thus been created over and above the regulatory minimums that would trigger action on the part of the monetary authorities. Their purpose is precisely to avoid any excessive cost for taxpayers. These contingency cushions must be built up by banks by retaining operating profits, which means it is prohibited to distribute dividends or premiums to directors. These cushions are also separate from the best-known contingencies, which are linked to the size, complexity and systemic nature of different institutions and with the macro-economic and financial development of their respective markets.

- **Third,** this preventive approach on the part of supervisory authorities grants them a rising degree of discretionary power when it comes to applying what is known as Basel's "Pillar 2". This discretion entails certain risks and also demands a change of culture and implementation on the part of the supervisory authorities. The extent of this change has been very different in the countries that are subject to the ECB's supervision, in practice that of the Single Supervisory Mechanism, given that it crucially depends on what the previous model was like. In many countries, such as Spain, these changes have been significant, given that both the supervisors and the supervised have had to move from a somewhat backward-looking model, based on accounting regulations and the strict fulfilment of ratios and asset classifications, as defined by the supervising authority itself, towards a more forward-looking regulation and supervision model, one that inevitably demands value judgments on the part of the supervisory authority.

- **Fourth,** it is precisely within this context of preventive supervision that risk management acquires fundamental importance as a management concept and supervisory mechanism. The key manifestations of this new supervisory emphasis can be observed in the following developments: the separation of governance and risk management within the business realm; the participation of the body's managers and administrators in defining assumable risk and control of same; the validation, monitoring and internal and external auditing of risk control models; and the inter-relation between desirable and tolerable levels of risk within what is known as the Risk Appetite Framework (RAF) with incentive and remunerations policies.

- **The fifth** and final point in our summary of regulatory changes relates to the growing emphasis on good governance at financial institutions. Although the correla-

> **"Failures of information and coordination should lead us to rethink the logic of decentralised supervision for the small and presumably non-systemic banks that have remained the responsibility of the national authorities"**

tion between good governance and the probability of insolvency or liquidity crisis, or between governance and costs borne by taxpayers, is far from having been conclusively established within economic literature, the truth is that the magnitude of the crisis and its cost, together with the brutal reality regarding certain excesses concerning the use of information, related-party transactions, data manipulation or simple abuse of privileged situations, has led all jurisdictions to tighten their supervision of governance at financial institutions. This has possibly occurred to an unprecedented extent in relation to previous eras and, in some cases, may have led the pendulum to swing rather too far the other way. However, this is undoubtedly a defining characteristic of the new regulatory framework, one that is exercising quite an impact on the financial system.

3.3. A Note on Macro-Prudential Policies

Macro-prudential policies are one of the key new features amongst the series of instruments to be used by central banks in developed countries after the crisis, although it is true that they have been used fairly frequently before by emerging economies accustomed to tackling systemic banking crises, with all the significant effects this can have on the real economy, on output and on employment. It is worth briefly focusing on these policies, since they probably constitute one of the main alternatives to the current combination of extraordinarily lax monetary policy and growing regulatory requirements.

A recent paper from the International Monetary Fund describes the traditional objectives of these instruments[42], which can be broken down into three main goals: to avoid excessive increases in leverage; to limit liquidity risks and ensure availability and collateral prices; and to minimise feedback processes between the financial system and the real economy.

In order to lower leverage levels, capital requirements tend to be increased and intensified during upswings in the cycle, precisely because this is when crises tend to be brought about. In order to avoid the pro-cyclical effect of the regulatory framework, however, these capital requirements tend to be relaxed during moments of recession. The central banks have consistently applied the former measures, but seem rather more reluctant to apply the latter, which are equally necessary in order to reduce the pro-cyclical nature of regulatory instruments. In the same sense, the new regulatory framework has generally incorporated a series of dynamic forward-thinking provisions based on expected losses in the credit lifecycle as opposed to actual losses.

[42] Claessen (2014) presents an exhaustive analysis of the justification, objectives, instruments and degree of application of macro-prudential regulatory policies.

The risk of liquidity has been one of the main problems witnessed during the crisis, one in which liquidity has disappeared from entire markets and where central banks have been forced to become market creators. In order to limit this risk, the authorities can resort to establishing quantitative liquidity standards, as Basel III has done, both in the short- and the long-term; they can give priority to retail financing by limiting the credit ratio with regard to bank deposits; they can impose limits on term, current or rate imbalances; or they can calibrate guarantee policies by implementing haircuts under the heading of discount policy or establishing ceilings for maximum credit regarding the value of the guarantee.

The ultimate objective of these policies is to minimise the real impact of financial crises, to limit feedback processes between financial and real variables. But their use has a cost: they reduce output growth and employment during the upward cycle, which is why their consistent and general application is mainly restricted to periods of crisis, when they are less effective. In order to make progress in terms of their implementation, it is important to carefully calibrate their effects. In this sense, more and better studies are required regarding the way they interact with monetary policy, especially in non-conventional circumstances, given that they entail complex cost-benefit analyses in which creating realistic scenarios is an added difficulty. In order to contribute to a subsequent debate, Graph 14 presents a list of the main macro-prudential measures and an initial outline of how they can be used.

GRAPH 14.
A summary of main macroprudential policies

- **Aimed at borrowers**
  - Caps on loan-to-value (LTV)
  - Caps on debt-to-income (DTI)
- **Aimed at financial institutions**
  - Assets: Limits on credit growth (CG)
Limits on foreign lending (FC)
  - Liabilities: Reserve Requirements (RR)
Caps on Loans to Deposits ratio (LTD)
- **Aimed at building buffers**
  - Dynamic provisioning (DP)
  - Counter cyclical requirements (CTC)
- **An idea of their usage**
  - 42 put of 65 countries have used at least once in 2000-2013
  - More often in EM than in DE and tend to favour foreign exchange and liquidity related instruments (FC, RR)
  - LTV and DTI most widely used (24, 23 countries)

“The exhaustive use of both policies, monetary and regulatory, and the growing importance that the ECB has acquired, have led to increasing incoherence and raised reasonable doubts concerning their effectiveness”

3.4. Some Uncomfortable Developments

In the same way as occurs with monetary policy, although featuring considerably fewer public repercussions outside the closed world of the financial system, regulatory policy after the crisis has entered new, unexplored and shifting terrain. It has abandoned various traditional mantras, such as the idea that last-gasp liquidity provision should be penalised at dissuasive prices or that supervisory authority interventions must be appraised, previously announced and free of any discretional dimension. These changes are necessary, but they require further reflection and debate than they are currently receiving on the part of the academic community and, above all, amongst policy-makers. “Irrespective of how well they may be created, for example in terms of their internal coherence, new regulations must prove their effectiveness in reality and it is quite likely that they may need to be modified if they fail to operate as expected”[43]. In this respect, it may be worth briefly raising a series of rather more critical and less pleasant considerations for future studies.

It is worth remembering, first of all, that regulation is not free. It entails a cost – a growing cost – for banks. Using private sources, Graph 15 shows the intensification of world-wide regulatory processes, distinguishing between different geographical areas. Here we can observe a global phenomenon that has an especially intense impact on those jurisdictions where the crisis has hit the hardest, as might be expected. To this regulatory cost we must also add the cost of the fines and penalties imposed on financial institutions (Graph 16). This cost is certainly attributable to the excesses of the system and the poor management of financial institutions, but it also undoubtedly reflects the supervisory enthusiasm of the authorities and the retroactive application of stricter supervisory criteria.

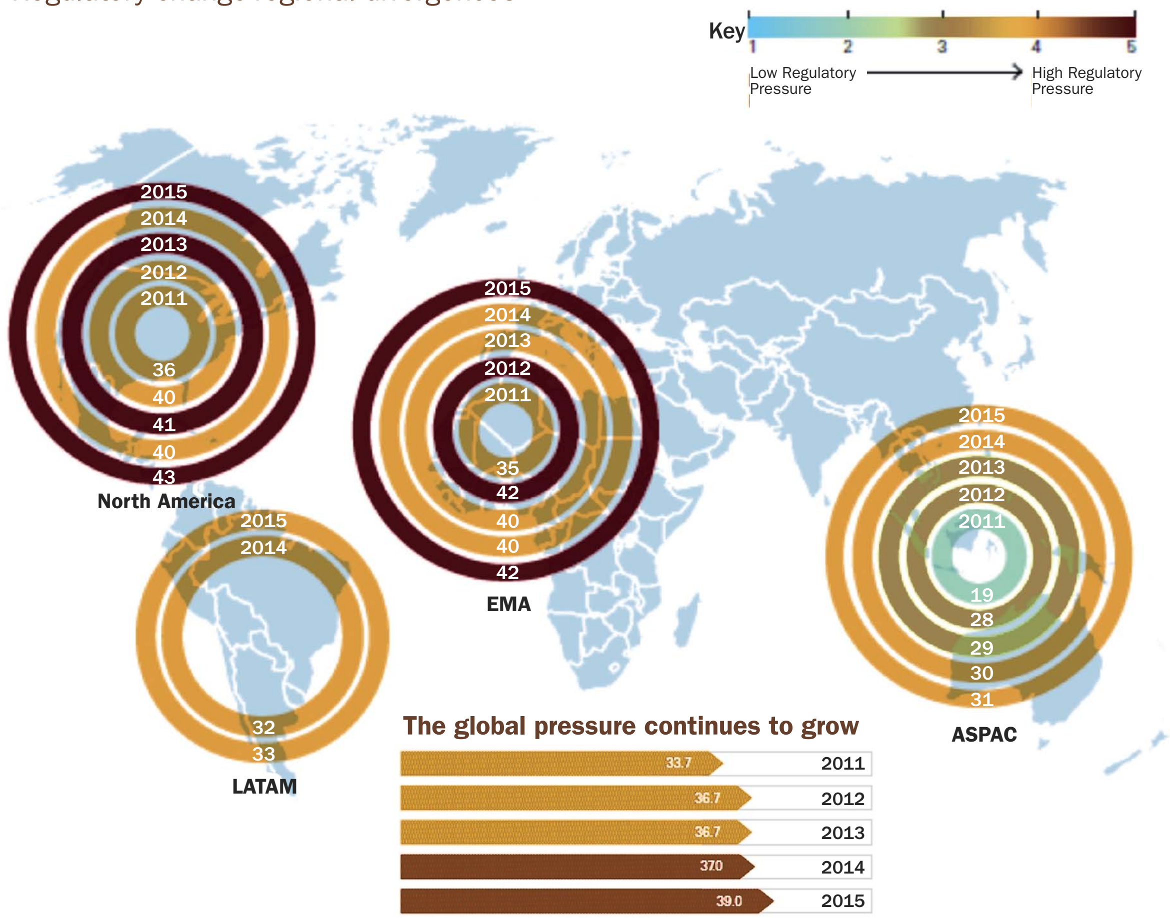
The regulatory development process has become excessively long, complex and sometimes contradictory, being one in which national, European and international legislation overlaps. These different pieces of legislation are not always compatible and their implementation is not always foreseeable. The result of all this regulatory inflation and administrative superimposition can be observed in Graphs 17a and 17b, which solely reflect all of the different pieces of solvency and resolution legislation applicable to the Spanish banking system.

[43] Bergés, A. and Valero, F.J. (2016), Shock regulatorio y debilidad del negocio: una peligrosa interacción para los bancos, Cuadernos de Información Económica Nº252, Funcas.

GRAPH 15.

Increase in Regulatory Pressure on Banks

Regulatory change-regional divergences



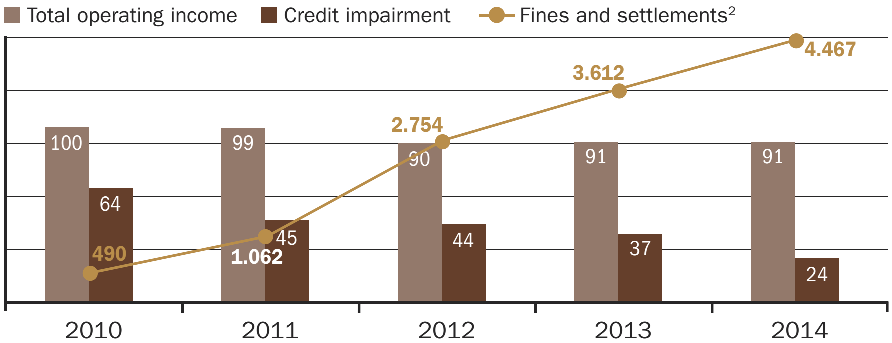
Source: KPMG, Evolving Bank Regulation, Part I, March 2015

Specific examples of this regulatory proliferation, one that has now spread into a number of controversial areas, include the following: (i) greater intervention in the management of commercial banks, which derives from new supervisory review and evaluation procedures known as SREP within the sector, which pertain to the preparation of capital contingencies, restructuring and planning “in conjunction with the supervisor”; (ii) an expansive interpretation of the “fit and proper test”, which has manifested itself in a disturbing tendency towards prior formal controls that unnecessarily delay the renewal process in the case of government bodies; (iii) the imposition of discretional limits regarding institutions’ maximum distributable amounts, without any precise and replicable results, which makes it difficult for institutions to plan in advance; and (iv) the proliferation of stress tests, in which pub-

GRAPH 16.

Since 2009, regulatory fees have increased dramatically relative to banks'earnings and credit losses

Performance of 20 large US and EU universal banks,[1] 2009-14, indexed to 2009 value (ie, value in 2009 = 10)



- Operating income has decreased by 10% over this period of time.
- Credit-impairment costs have decreased steadily over same time horizon.
- Meanwhile, regulatory fines and settlements increased y almost 45x.

[1] Calculated using company annual reports and press clippings from 2009 to 2014. Coverage includes top 20 European and US global systemically important banks (universal banks only) by assets.
[2] Amounts include paid fines and settlements only; does not include provisions, such as payment protection insurance in the case of UK banks.

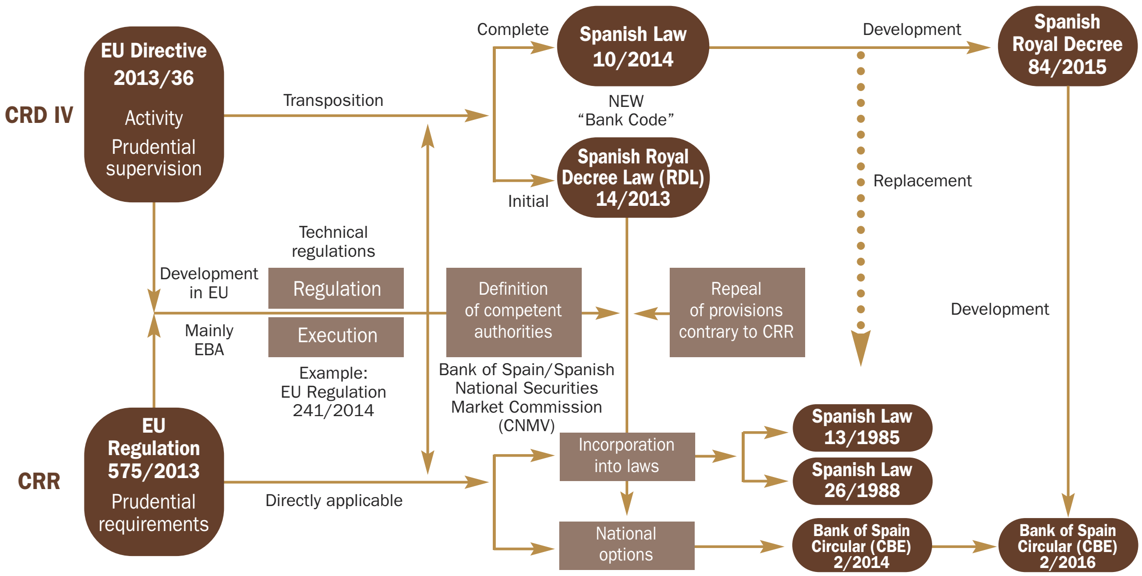
Source: SNL Financial; McKinsey analysis

lic opinion is led to believe that their use on a frequent basis is desirable as a supervisory procedure, instead of serving simply as a regulatory mechanism that defines minimum, enforceable or recommendable levels of capital, thus leading to certain measures at institutions that fail to meet these requirements.

It is true that this greater degree of intervention is a logical and desirable regulatory development, given that the previous state of affairs simply offered a series of extreme possibilities and "tight corner solutions". However, a series of inconvenient situations has arisen as a result. More intrusive and discretional bank supervision, basically for good and justified reasons, necessarily requires greater transparency, higher predictability and a better system of accountability, including the possibility of financial institutions being able to appeal regulators' decisions in the courts. This represents a collective learning process for the sector, encompassing both regulators and those who are regulated, one in which a greater sensibility on the part of regulators regarding the dynamics and obligations of the market would be welcome. Episodes such as the ECB's insistence on keeping its specific capital requirements and recommendations secret in the case of each separate body, in spite of the latter's legal obligations to the market authorities, with their corresponding market commissions, and to their shareholders and potential investors, are not at all laudable and show that it is not only financial institutions that are in the midst of a significant cultural transformation process.

GRAPH 17a.

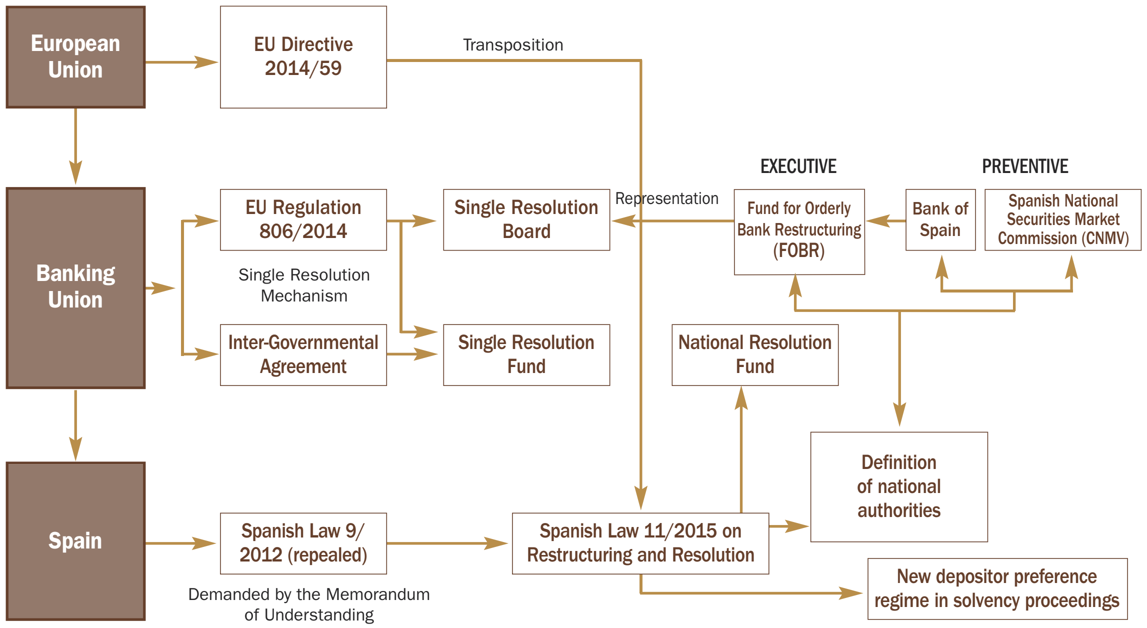
General and Solvency Regulations Applicable to Spanish Credit Institutions



Source: Bergés y Valero, Shock regulatorio y debilidad de negocio: una peligrosa interacción para los bancos, *Cuadernos de Información Económica*, Nº 252, Funcas, May-June 2016.

GRAPH 17b.

The Resolution of Credit Institutions in Spain



Source: Bergés y Valero, Shock regulatorio y debilidad de negocio: una peligrosa interacción para los bancos, *Cuadernos de Información Económica*, Nº 252, Funcas, May-June 2016.

“Monetary policy has gone too far. Europe has been left without any margin for manoeuvre in the face of a new deterioration in the macroeconomic outlook”

As part of this process of regulatory change, if there is one thing that all financial institutions demand it is regulatory stability and clarity[44], the equivalent of legal security in economics. Only then can they plan ahead, take decisions and fulfil these stricter requirements without detriment to their business activities. After seven years of ongoing regulatory change, international coordination efforts are flagging, without even mentioning the “Brexit” affair. Too many questions are still being debated in Europe. In my view, the most important include the following (i) the specific definition, measurements and eligible instruments for the leverage ratio (LR), for the net stable funding ratio (NSFR) and for minimum required eligible liabilities (MREL) and their compatibility with total loss absorbing capability (TLAC); (ii) the regulatory and accounting treatment of government risk in financial institutions’ portfolios (iii) and the harmonisation of different national regulations regarding eligible instruments such as AT1 (Additional Tier 1 Capital) and AT2 (Additional Tier 2 Capital), given that doubts concerning applicable bail-in regimes is making it difficult to create a market featuring sufficient liquidity and a price that does not penalise the issue of an instrument that is effectively required by the regulator.

The Eurozone is an especially complex monetary jurisdiction, which is simultaneously witnessing the development and application of a new international regulatory policy and experiencing the harmonisation of a series of extremely heterogeneous national models, a process that is essential in terms of granting the Union a degree of consistency and stability. This complexity increases because financial and banking regulation is approved and applied for the entire European Union, either through the Commission or through the EBA, the European Banking Authority, including the United Kingdom up until now, which has obviously played a leading role. Supervision is restricted to the jurisdiction of the Single Supervisory Mechanism (SSM), basically the EMU, and is centralised at the ECB.

The ECB’s work in this field deserves praise[45], because, at an especially difficult time, it has been capable of implementing a new set of regulations and a new supervisory approach without any significant incident and without excessive alarm or

[44] This is a common denominator in all documents issued by organisations within the sector, such as the Spanish Banking Association (AEB), the European Banking Federation and the Institute of International Finance (IIF).

[45] And we have explicitly and extensively praised the European Central Bank in other studies, such as the *Anuario del Euro 2015*, which tackles the themes that follow more closely and in greater depth.

emotion. However, in spite of the introduction of the Single European Supervisory Mechanism in November 2014 and the strict audit standards entailed by what are known as 'Comprehensive Assessments', it appears that some national authorities have continued to retain a certain degree of protection for their banking systems, a certain regulatory forbearance. In this respect, failures of information and coordination should lead us to rethink the logic of decentralised supervision for the small and presumably non-systemic banks that have remained the responsibility of the national authorities[46].

The ECB's insistence on limiting the use of the multiple national 'options and discretions' that are permitted in the application of CRR/CRD IV is welcome, but a more transparent and sometimes more balanced debate is required amongst the different national partners. It should be a priority to create a clear roadmap for the final model and this would enable the different parties involved to discuss solely the different adaptation periods, in a similar manner to the integration processes entailed in establishing the Union. Emerging from the current *impasse* cannot consist of going back along the path that has been trodden, of reinterpreting the European regulations enshrined in the Bank Recovery and Resolution Directive (BRRD), even though the IMF itself seems to be in favour of reinterpreting it at times when it expresses its doubts regarding bail-in procedures and creditor losses[47]. Because the key fact of the matter is that a recently-approved European regulation exists precisely for cases such as this, which comes down to the BRRD and the Single Resolution Mechanism (SRM)[48]. This regulation is based on a two-fold logic: minimising the cost to taxpayers, who would only take part in systemic bank rescue measures after shareholders and creditors have assumed their losses; and progressively mutualising European bank debt in exchange for the de-nationalisation of decision-making. This is a necessary condition, since there cannot be European responsibility without European control. If these regulations are not fulfilled, if exceptional measures are adopted for the first significant case that appears on the horizon, who is going to continue placing their faith in the European project? Who will be able to claim that the banking union is a reality, something that might one day resemble an optimum monetary area?

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[46] Dell Ariccia, G. (2015), *Governance and Policy Challenges of Forming and Running a Supervisory and Regulatory Union: A Theoretical Perspective*, European Economy: Banks, Regulation and the Real Sector.

[47] "Directors considered that effective use of the framework for the prompt resolution of banks is important. Recognizing the adoption of the Bank Recovery and Resolution Directive (BRRD) framework, they noted that concerns related to the bail-in of retail investors should be dealt with appropriately". IMF, Executive Board Concludes 2016 Article IV Consultation with Italy. Press Release No. 16/329

[48] A regulation whose reasoning is packed with references to how it would work in the case of a possible crisis in the Italian banking system. Commentators cannot, therefore, plead ignorance or claim that we are dealing with an unforeseen problem, another 'black swan'.

“Monetary policy in the form of unlimited quantitative easing has provided the perfect excuse to delay certain inevitable decisions and postpone a series of necessary structural reforms in order to combat secular stagnation”

In short, this final roadmap cannot differ that much from other established monetary zones and must not incorporate traditional suspicions and weaknesses, what are known as legacy costs. Specifically, it does not seem very sensible and it would not be very sustainable for the European Union and the ECB to make government bond holdings in bank portfolios very different to those held in the United States. The final roadmap must contemplate the existence of Eurobonds, a safe asset for the ECB’s monetary policy operations, featuring a regulatory and accounting regime that recognises these as a risk-free asset. Furthermore, national government bonds should be understood as subnational entity debt, in the words of the IMF, whose regulatory and accounting treatment must be coherent with regard to the solution that is reached for Fiscal Union. The political sensitivity of these regulatory questions is understandable, because they affect the banking systems of the different countries differently. However, this cannot serve as an obstacle and mean that the European financial system remains without a clear end goal, given that this poses a serious complication regarding institutions’ strategic planning.

In summary, the key question for the purposes of this article is whether this more intrusive and more demanding regulatory policy in terms of capital and liquidity levels at entities is compatible with:

1. An extraordinarily expansionary monetary policy whose application over time might produce undesired collateral effects of increasing intensity.

2. The cyclical moment in which Europe’s economies find themselves, which might lead to a different calibration of certain regulatory safety cushions.

3. The absence of any coordinated fiscal policy in the Eurozone and an undefined stance on fiscal policy within the Union and on the policies that are appropriate for the different countries according to their differing degrees of fiscal consolidation, not to mention the rules to be applied in case of non-fulfilment.

4. Insufficient progress regarding the construction of a sustainable monetary union, as witnessed by the difficulties in approving a European Deposit Insurance Scheme or the definitive mutualisation of the Resolution Fund featuring a direct debt capacity.

4. Conclusions

The potential incompatibilities between monetary policy, which seeks to ensure economic stability, and regulatory and supervisory policy, which seeks to achieve financial stability, are nothing new. This is a well-known theme in academic literature and was extensively debated during the discussions for banking union, for example when it came to agreeing the institutional framework for single regulation and supervision. This question became even more complicated when financial regulation affected the four basic freedoms of the European Union, which led to the creation of the EBA in addition to the ECB. Furthermore, for pure reasons of institutional effectiveness, and overcoming the misgivings of certain countries, the ECB took on a series of supervisory functions in addition to its traditional monetary policy activities, but featuring a kind of Chinese wall between the two functions in the form of two different Boards for monetary policy and supervision. The great theoretical advantage of this design is that it permitted better coordination between the two policies and, above all, guaranteed the efficient use of confidential information in real time.

The exhaustive use of both policies, monetary and regulatory, on the part of the European Union and the growing importance that the ECB has acquired regarding both policies, has led to increasing incoherence and raised reasonable doubts concerning their effectiveness. It is true that Europe's monetary authorities have not strayed that far from the measures introduced by the central banks of the leading countries throughout the world, such as the US Federal Reserve and the Bank of Japan. The ECB has been harshly criticized for acting late and without conviction, but the possible alternatives were few and we will never know what might have happened in Europe without the ECB's decisive measures in the summer of 2012. However, the non-existence of a counterfactual analysis should not prevent us from questioning the cost of the policies that have been chosen, the contradictions that have emerged and the alternative options available. This has been the purpose of this article.

Since mid-2014 the ECB has adopted a series of extraordinarily expansionary non-conventional monetary policies in terms of the size of their balance, the instruments employed and their impact on market interest rates, reaching the point of establishing a negative deposit facility rate, something that other central banks in developed countries have not dared to do. These measures may have been reasonable at specific moments of maximum risk of recession or deflation, but they cannot be applied permanently, given that their effectiveness diminishes over time, giving rise to falling yields, and because they exacerbate a series of adverse effects regarding the stability of the system. As we have argued in some detail, negative rates generate perverse incentives regarding the saving decisions made by individuals, they entail an important cost in terms of the profitability and solvency of financial institutions, and they draw out public debt sustainability problems because they facilitate debt servicing by lowering external budget restrictions on governments. Furthermore, they reduce the possibility of structural reform by generating undesired effects within the realm of political economics.

In my opinion, monetary policy has gone too far. Europe had been left without any margin for manoeuvre in the face of a new deterioration in the macroeconomic outlook, especially when the economic climate in the year 2015 was not that critical. In fact, haunted by the prospect of deflation, the ECB has intensified its expansionary policy when a certain recovery in output and employment within the Eurozone has become a reality, possibly confusing the terms of trade shock and the change in absolute price levels with a problem of deflation. But such an aggressive approach has raised some important additional questions. Is monetary policy the appropriate instrument for boosting economic growth within an imperfect monetary union? Has the ECB, the only truly federal institution in the EMU, not taken up an impossible stance by promising what it cannot give? We might say that the ECB has done rather too much, too soon.

The consolidation of monetary union and institutional changes that might bring Europe closer to its optimum monetary design are essential in terms of enabling the Eurozone to emerge from the crisis. Within this context, monetary policy in the form of unlimited quantitative easing, by offering a politically easy solution to a series of complex institutional issues, has provided the perfect excuse to delay certain inevitable decisions, such as the creation of a European Bank Deposit Insurance Scheme or the definitive creation of a Single European Bank Resolution Fund featuring its own debt capacity and a credible fiscal backstop. The current policy has also served to once again postpone a series of necessary structural reforms in order combat secular stagnation. This has been an easy way out, but one that is inefficient and, over time, counterproductive. There is no monetary policy that can possibly prevent a structural adjustment to ‘new normal’ circumstances.

After the crisis, financial regulation and supervision policies have also been used assiduously and with laudable enthusiasm in Europe. In order to ensure the stability of the financial system, protect consumers and reduce the cost for taxpayers, financial regulation has clearly evolved towards demanding more and better capital, thus increasing its preventive capacity and ensuring appropriate risk management, whilst also enhancing governance quality and control and, above all, increasing the discretional powers of regulators. This discretional authority is essential, as we have argued, but it has not been accompanied by the necessary transparency and accountability.

The key question is whether this more demanding and intrusive regulation has been coordinated appropriately with regard to monetary policy and calibrated to

"The alternative option in Europe would mean making clear progress in terms of mutualising bank and government debt in exchange for greater fiscal discipline, whilst normalising the Monetary Union and ending exceptional cases"

take into account the cyclical moment currently affecting the European economy. It does not seem very coherent to demand more capital and better risk management at financial institutions whilst simultaneously pressuring them to increase lending levels, penalising them for having reserves and making it difficult for them to achieve reasonable intermediation margins. The cyclical climate currently affecting Europe's economies should lead to a different calibration of regulatory policy based on adjustments in capital cushions, the intelligent use of macroprudential policies and a less aggressive monetary policy. However, turning the current policies around is no easy matter, because one fundamental problem with unconventional policies is that they do not include an exit procedure.

Perhaps the real political question is whether an alternative exists. I believe it does, although this is not the subject of this article, which has simply outlined some of the contradictions in current policies. This alternative option in Europe would mean making clear progress in terms of mutualising bank and government debt in exchange for greater fiscal discipline, whilst normalising the Monetary Union and ending its exceptional state, which is a constant source of instability. This option would give the leading political role back to those who should have it, namely the European Council and the European Commission, this allowing the ECB to return to its discreet and limited – albeit crucial – role of calibrating monetary policy and implementing financial regulation and supervision in order to guarantee economic and financial stability. Nothing more and nothing less. I am sure both Mario Draghi and his Governing Council would be extremely grateful.

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