EXECUTIVE SUMMARY. RETHINKING THE EU. CONSOLIDATING EMU IN A FRACTURED WORLD

Fernando Fernández[1]

1. THE EUROPEAN UNION IN A FRACTURED WORLD

The world as we have known it for almost a century seems to be coming to an end. Globalization, free trade, international cooperation, democracy, the market economy, the rule of law, are all being questioned and restricted in large parts of the world, and from very different political perspectives. Apparently, and this is a matter of serious concern, there is a large and growing public opinion that these old mantras need to be revised, managed, reinterpreted, adapted. In other words, abandoned and substituted for a new world order. A world order that seems dangerously defined by strong and charismatic authoritarian leaders with no respect for due processes, no consideration for the necessary checks and balances, no limitations to the use of power, and no time to waste to save us from whatever dangers they seem fit. Politics are becoming discretionary if not capricious. Economic policies unpredictable and irrational. Mercantilism is on the rise. Government intervention in the economy is increasingly pervasive. Economic arguments that would be considered extreme, marginal or simply wrong, are now the foundation of many policy decision with profound global consequences. And not only in the United States of America.

Two words define the global outlook, uncertainty and fracture. Uncertainty because nothing can be taken for granted any more, and nothing may last more than a twitter

[1] Fernando Fernández Méndez de Andés, professor of Economics and Finance, is currently a member of the Board of Governors of Banco de España and of its Executive Council. Editor of the Yearbook since the first edition. The opinions expressed in this summary, when not explicitly attributed to the authors of the different chapters, are exclusively his own and may not, under any circumstance, be interpreted as representing the views of Banco de España and the Euro system.

news cycle. Everything is now possible, including war conflicts escalating and spreading globally. And it is more than just possible that the United States of America, the political, ideological, and economic anchor of the old world order, decides to abandon it as its leadership becomes convinced that it does not play to its advantage any longer, the trade deficit being simply an excuse. It would be reassuring to believe that it is just Donald Trump´s obsession to make America great again, but who could guarantee that his XIX century vision of America will not survive his presidential term? At the same time, does anybody really know what President Trump wants to do with China, Russia, NATO, Ukraine, trade tariffs, the dollar, digital assets, etc.? Does he know? Not surprisingly, political and policy uncertainty indicators are at extremely high levels. And they will continue to stay there for quite some time.

Fracture is the other major theme. Political and economic fracture that goes far beyond the divisions of the cold war. Then, the international divide was simple and clear cut. The world was neatly split between friends and enemies. With friends, which were trusted, one cooperated, traded, negotiated and offered support in times of need. To enemies, one fought endlessly and tried to bring into your camp. But those marching lines, those clear camps are simply not present anymore. Who defends traditional "western values"? who are Europe's allies? Which countries, what leaders share our values and vision of the world? Do we even have the same values inside the EU? This fracture runs deeper than fragmentation; the different parts of the world are drifting away, and they show no interest in re-approaching nor in at least keep talking. This fracture will last, because trust has been seriously eroded. Reconfiguring a new world order will take time, and will be messy and costly. The American friend that saved Europe from its demons twice in the XX century cannot be trusted anymore. It is obviously not the reliable partner Europe needs in Ukraine to contain Putin's expansionism. And it is certainly not the reliable partner Europe needs for the digital revolution or the energy transition. Not to mention the issue of how to respond to China´s claim for power.

Political scientists will need to work hard in explaining how this fracture came about and what to do to mend it. Fortunately for economists, we are entrusted with a much simpler role: assess the consequences of this shift in values, policies and priorities; propose alternative scenarios and offer some remedies to limit its substantial costs. And to start doing this, we have dedicated the 2025 Yearbook which once again has been adapted to the changing political European landscape.

The old order is dying, but the new order is not even pregnant yet. Europe's role in it is a question mark. The prevailing naïve optimism about our ability to shape the future as the standard setter of the world is unjustified. The risk of marginalization cannot be ignored. Empires, global powers, dominant cultures are not eternal. Europe will need to strengthen its political, economic, and military might to be decisive or at least significant. In all these three fronts there are institutional reforms that have been unduly postponed, entrenched policies to change, large investments to make. All of them will require strong leadership and high political capital, two commodities in short supply these days in Europe. It means advancing the federal idea of the Union while improving its democratic legitimacy and accountability. Because the European Union is more needed than ever in this fractured and uncertain world. Needed both for its member states and for the world. No individual European nation has a chance to play on its own any meaningful role in a polarized USA-China regime. The EU foundational idea of economic interdependence to foster peace, social development and human well-being is a necessary lighthouse in times of growing nationalism, isolationist tendencies and mercantilist economic policies.

In our concrete sphere of interest in this Yearbook, economics, it is safe to assume that the new world order will come with an increase on trade tariffs. The magnitude of which still uncertain. As it is uncertain the response of the rest of the world to the unilateral decision of the USA administration. At this point it is clear that there will be some form of retaliation, however carefully targeted, from the European Union. Discussions in Brussels range from an open trade war with the USA in the TACO spirit (Trump always chickens out) to a more balanced and selective response in fear of causing a global recession. A recent debate between two world class economists and friends, Larry Summers and Olivier Blanchard, was very illustrative to this effect, with the American emphasizing basic economic theory that retaliation only hurts the country tant embarks on it, and the French requiring a swift and harsh political response to American unilateralism. It is therefore convenient to remind the reader of the basic economics of trade tariffs. Although it may seem intuitive that taxing imports would reduce net imports, tariffs do not have a direct impact on the balance of trade. The trade balance is driven by net lending and borrowing between the United States and the rest of the world. Instead of reducing net imports, tariffs simply reduce overall trade, and therefore economic efficiency and global growth.

Additionally, tariffs tend to appreciate the currency of the country that imposes them, in this case, the US dollar. If this has not happened, it is because the unpredictability of Trump economic policy has eroded confidence on the USA and on its currency. The fact that the US dollar, the so far undisputed reserve currency of the world, is not performing as safe haven is a major source of financial instability in the short run. But it may also create an opportunity to consolidate the international role of the euro beyond its current status as a purely regional currency. The fact that other imperfect substitutes, mainly gold and digital assets, bitcoin mostly, are currently playing that role of providing security, is a clear indication that investors find the Euro Area lacking some necessary institutional and market features.

Completing the Monetary and Capital union, the Savings and Investment union, SIU, is an obvious step, as the Commission has adequately stated. Although most of the necessary work is legislative and political in nature, and its implementation will fall mostly on the European Securities and Market Authority, ESMA, there are certain things the ECB can do to facilitate it. The simplification of its prudential, supervisory and regulatory activities, a work in progress at the Governing Council and the Supervisory Board of the ECB, will help the SIU. Ensuring that bank liquidity can circulate freely in the Eurozone, avoiding national forbearance of deposits, should be a priority, but it would require advancing with EDIS, the European Deposit Insurance Scheme. Banking crisis management could be consolidated into a strengthened Single Resolution Board that integrates all national relevant entities and merges deposit guarantee systems. Moreover, including the competitiveness of the Euro financial system as an explicit objective of the ECB supervisory review would facilitate banking union and ensure an efficient European banking system in a level international playing field. As previous editions of the Yearbook which have treated CMU extensively have argued, if the EU is this time serious about a long overdue project, it will need to think through the current distribution of competencies in these areas between the Union and its member states and consider further transfers of sovereignty.

Enlarging the pool of zero risk euro assets is also mandatory for financial markets in euros to gain sufficient depth and liquidity, a necessary condition for the euro to become a world reserve currency. Financing the security, defense, and energy transition, obvious common public goods, provides the opportunity. But at the cost of complicating the financing of member states sovereign debt, since overall public indebtedness in the European Union is already at very high levels and crowding out effects are a real possibility. Time to make hard choices in Europe. Debt incrementalism will not work. Further tax increases will only erode growth potential and exacerbate productivity problems.

Finally, economic intuition would suggest that tariffs, like other excise taxes on products, should raise prices. Whether it results in a one-time adjustment to the price level or a persistent increase in the rate of inflation, will depend on (i) the response of the European Central Bank, (ii) the reaction of other countries, i.e. China, trying to substitute for the US market and unloading its "excess exports" in Europe, and (iii) in the probability of a global recession.

The international trade outlook has deteriorated markedly. But there is much the EU can still do by deepening its internal single market, as the highly quoted Letta and Draghi reports have reminded us. Removing remaining barriers to trade within the EU, moving decisively in service trade liberalization, and advancing the capital markets union would provide European firms with a large customer base, a necessary condition for increasing size and productivity, accelerating the adoption of new technologies and augmenting R&D investment. A careful reconsideration of EU competition policy is in line to account for the "relevant European market". But productivity enhancing policies also require strong domestic efforts: (i) easing remaining administrative barriers to entry in many sector and occupations, (ii) shifting labor market regulations to protect workers, not jobs, (iii) encouraging business dynamism and rotation, and (iv) tax policies that incentivize firm growth and reinvesting of firm benefits. In sum, EU economic policy should refocus on fostering economic growth and creating an attractive business friendly environment if it wants to compete in the new world order. Unfortunately, the European political debate is too often limited to finding new ways of providing more public funding, more active industrial policy, more state intervention in so called strategic sectors. The European Union needs to find a way out of this doomed loop.

A new world order is emerging, and the role of Europe is not guaranteed. Global priorities have shifted to defense, security and economic nationalism. None of which appeared in the top of the European agenda a few years back. Although following through on the European Green Deal may seem still a priority, the EU needs to trim its climate ambition in light of political realities, are we willing to tax European companies and citizens in splendid isolation? and consider systematically the growth and employment costs of climate action, once the illusion of a free transition has vanished. At this critical global juncture, it seems mandatory to defend what is most important, an open rules based international economic order. To this effect the European Union should apply whatever international political capital it has, whatever soft power it maintains. But at the same time, it has to work on reducing its vulnerabilities, political and economic, to improve its hard power. Politically, governance reform and changes in EU decision making are mandatory. Majority voting should be widened to new areas. Neither enhanced cooperation nor even treaty changes could be off the table, as we have been consistently arguing for years. Economically, low productivity and high sovereign debt are problems to be urgently addressed. Both would improve by completing the internal market and the Monetary and Capital Union, and by focusing policies on economic growth and creating a business friendly environment.

2. CONSOLIDATING THE MONETARY UNION

This 2025 Yearbook is once again a collective effort. I have been fortunate to have as contributors an impressive list of professionals from very diverse background, perspectives, current positions, and past experiences. But they all share two common understandings. One, that the European Union is a much needed stabilization factor in the current fractured world. But two, that the EU needs to change to continue exercising its positive and significant influence. And to that effect, they provide the reader with the tools to understand what is happening and what needs to happen. As editor, I have tried to cover all relevant policy discussions in Europe in the limited arena of economic and financial policies. I have also maintained in this executive summary my prerogative, for the benefit of the reader, to complement or question some of the recommendations of the different authors with my own views.

If in 2024, the Yearbook left a unanimous sense of satisfaction and concern, concern is the only conclusion of 2025. A concern that goes beyond our usual preoccupation for the many issues left unsolved for too long in the Monetary Union. Issues that could one day make us pay a heavy price in term of social, economic and financial stability. A concern for the state of the world, for the immediate future and for the potential long lasting scars on our well-being as global citizens. But this concern cannot distract us from our obligations. And the obligation of the Yearbook is to shed light on the fiscal, monetary, and regulatory aspects of the European Monetary Union.

Contrary to past editions, this yearbook is not organized in the traditional four sections -the context, monetary policy, fiscal issues and regulatory policies-, although it covers all those four. This time it is more issues oriented. This Yearbook edition starts by describing the uncertain political outlook and potential outcomes, followed by analyzing a key structural economic problem of Europe: insufficient productivity growth.

Then, we try to explain what it means for monetary policy in general and for the ECB in particular the awakening of inflation after a long period of concern about deflation. Two fiscal issues are considered this year: (i) the first-time unsatisfactory implementation of the new EU fiscal rules, (ii) the problems in Germany and France and what they mean for the sustainability of the Eurozone. Two financial issues in regulation follow: (i) the simplification and harmonization of financial regulation and the competitiveness of the EU financial system and (ii) the challenges to maintain a level international banking playing field. The Yearbook ends with two studies on digital finances: (i) a critical assessment of the digital euro project, and (ii) an evaluation of the EU approach to regulating digital assets, DORA.

2.1. THE POLITICAL, ECONOMIC AND MONETARY CONTEXT.

The Yearbook starts studying the political context, providing an account and interpretation of the international outlook and political developments within the European Union. This year, this is a more obvious need. **José María de Areilza** writes in chapter 1, *Europeans in a world of dysfunctional superpowers*, a paper that asks a fundamental question, how should Europe approach Trump´s implosion of the international order.

The author explores the shifting geopolitical landscape and its implications for Europe. The document highlights the end of a long era in international relations, “the end of the end of history.” Lasting wars, such as those in Ukraine and Gaza, accelerate historical changes. The return of large bloc confrontations, particularly between the U.S. and China, is evident. The focus of foreign policies has globally shifted from global prosperity to national and regional security, a worrisome and widely encompassing term. Perhaps not surprising, the rise of “strongmen” autocratic and charismatic leaders with simple solutions to complex problems is evident in both democracies and autocracies.

For Europeans, and for all those who believe in a rule-based liberal order and market economy, Trump’s second presidency is bad news. In a few months Trump has broken bridges with its allies, inflicted unnecessary damage to its economy, put the dollar exorbitant privilege at risk, and pulverized American soft power. His foreign policy, a populist mix of isolationism and imperialism, questions the western alliance of values and policies and weakens transatlantic relations precisely when it is more needed, when Russia and China are challenging it militarily and ideologically. And it stresses the internal cohesion of the Union.

Trump can be no excuse for Europe to face reality. The US, with or without Trump, is withdrawing from Europe. Its strategic goal is elsewhere, containing China. For many decades now, the Unites Sates foreign policy priority has been to contain China, the rising superpower rival. Trump did not change that priority. It has “only” brought chaos and unpredictability to its implementation. But also, for a long time, with different parties and presidents in office, the US has not been confident that it can count on Europe for that challenge. At the same time, Russia, the number one security problem for Europe, is increasingly a marginal issue in Washington. And we have not been able to convince America, and many other countries, of how serous this threat is to stability, prosperity, and peace.

This chapter raises an important red flag when arguing consistently that the two alternative strategies currently being discussed in Brussels and European capitals are unrealistic. First, decoupling from the USA is politically, technologically, economically and energy wise, simply impossible. Even more so, to do it on time to confront Russia. But Trump has brought to new life the old dream, to some of us the nightmare, of building Europe against America. Second, political rapprochement with China arguing trade and economic considerations, precisely when under Xi Jinping is retreating to statism and turning its back on human rights, is equivalent to surrendering everything Europe has believed and worked for since the Enlightenment. But Areilza is an optimist by nature and argues for a new approach. One that will require intelligence, patience and vision. Europe must preserve its Atlantism, continue to engage and negotiate endlessly with Washington while developing its own capabilities, widening its options and reducing its obvious vulnerabilities. One presidency, no matter how long and harmful it might be, should not, cannot, make us forget that the United States and Europe share the same values. Let me add my own emotional pitch to Areilza's much more sophisticated thinking, the US did not abandon Europe when the continent submerged in its darkest hours. Beyond our common economic interests, we owe Americans that much.

Europe is obviously not comfortable in a world where security is paramount, but it must adapt to it, requiring a shift from introspection to strategy. Too much time is spent in Europe looking internally at its own problems, its heterogeneity and the need for internal reform. This Yearbook has argued consistently for the need to complete the European architecture, particularly in our area of interests, economic and monetary union. A call for reform that needs to be extended beyond that more technical realm. The centralization of security and defense policy in Europe requires the strengthening of democracy and legitimacy of the Union. "It is a question of being able to take decision effectively, with a much larger budget and with institutions subjet to the rule of law and more able to be accountable to the citizens".

The EU has faced multiple crises, not only economic. It must now formulate a political strategy to become a significant geopolitical actor. This includes developing defense capabilities, strengthening the economy, and maintaining the transatlantic link. Europe must be a leading force in avoiding the trap of realism in international relations, the power of force, and continue to advocate for diplomacy, negotiation, and a rules-based world order. For this, Europe has to be able to display more than just soft power. The EU's reaction to Trump's policies should be strategic, aiming to renew multilateralism and economic and political freedom.

In chapter 2, the Yearbook begins to focus on the economic and monetary union. During 2024, the Euro Area economy experienced a gradual and very modest recovery in activity while inflation continued its convergence to the 2% target. In this context of falling inflation pressures and insufficient growth, the ECB started in June the normalization of its monetary policy, i.e. reduction of interest rates, and continued shrinking its balance sheet. As it is well known, this benign global economic outlook changed drastically with Trump trade policy to the point where uncertainty is at its highest and every economic outcome is possible, although to this date no major economic disaster scenario has materialized. Fortunately for the editor, and the reader, the Yearbook is not about forecasting short term performance, and we have replaced the traditional chapter on the evolution of the European economy for an analysis of one key structural issue, productivity, the principal determinant of real wages, purchasing power and long term growth.

Juan Francisco Jimeno calls his chapter, *Lagging behind: Productivity Growth in the Eurozone and the USA*, and consequently addresses the two issues, explaining the lag and making policy proposals to revert this negative trend. Productivity growth is the only feasible source of sustained economic growth and social welfare over the long run, as increases in income and consumption per capita, leisure time and resources for public policies can only arise from higher productivity. The fact that Europe has a productivity problem is well known and has been on the policy agenda for a long time. Too long because in the meantime it has gotten worse. This concern explains why the Draghi and Letta reports have become the most quoted pieces of economic analysis in Europe and have led the Commission to present its Competitive Compass in January this year. Let us hope with the authors that this time is different, and nice words are followed by concrete actions.

To this effect, Jimeno discusses the productivity growth trends in the Eurozone and the USA, highlighting the widening productivity gap between the two regions in historical context, providing the most recent data, and explaining the main drivers of productivity, such as technological adoption, investment in capital, market flexibility, and regulatory environment.

The long-run trends are relevant for various reasons. Most importantly, they show that minor changes in growth rates sustained over time result in large differences in productivity, and therefore in GDP per capita. Thus by 2022, Europeans worked 13% less hours than in the US, a difference that translated into about one third lower GDP per capita. And can be mostly traced to "the effect of the marginal tax rate on labor income". A blunt reminder that the famous European preference for leisure may just be the consequence of the high tax burden on labor income.

Recent data detailed in this chapter also show that productivity growth has been higher and has contributed more to GDP growth in the USA than in Europe in this XXI century. This higher productivity performance in the USA is mostly in the services sector, particularly in those subsectors with higher technological content. And this gap widened further after the COVID-19 crisis, since the USA adapted more effectively to new post-pandemic economic conditions, while Europe struggled with slower recovery. Perhaps, I may add, because of its excessive protection of zombie companies and zombie jobs. Interestingly, standard shift-share analysis by Jimeno concludes that intra sector changes in productivity are the main drivers of productivity growth across time, which speaks for fostering and not impeding firms' dynamics.

As we know, growth can only be the result of: (i) the use of more and better labor,

(ii) the use of more and better capital, and/or (iii) the increase in Total Factor Productivity, improvements in the combined use of both of the above. Standard growth accounting reveals that the USA's advantage stems from higher human capital, better investment in advanced technologies, and a more favorable regulatory environment. In contrast, Europe faces slower productivity growth due to lower investments and excessive regulation.

Two structural trends will condition economic and productivity growth in the next decades, the development and adoption of technologies associated to robotics and artificial intelligence, and demographics. This chapter emphasizes that "so far AI technologies are not so much substituting human labor as they are complementing skilled workers" and that Europe has lost the race in the developments of LLM (Large Language Models) the foundations of Generative AI.

Ageing of the working age population slows down productivity through three channels. Productivity growth is lower (i) at the late years of the working life, (ii) at all age groups in countries where population is older, and (iii) with a less balanced age structure of the working-age population due to age complementarities. In the context of continuing reduction of working-age population, productivity growth thus becomes even more important. A further reason for Europe to improve its efforts both in fostering the development and adoption of new technologies and in improving its regulatory and fiscal environment.

As the Euro Zone appears to have weathered the inflationary surprise with little damage in terms of foregone output and employment and is entering a new monetary cycle, **Pablo Hernández de Cos** writes chapter 3, *Reflections from the last inflationary episode*. The Euro-area economy experienced several shocks, leading to the highest inflation since the creation of the European Monetary Union. After a detailed and technical revisions of several features that could have altered the transmission mechanism of monetary policy[2], Hernández de Cos concludes that the monetary policy framework adopted by the ECB in 2021 was instrumental in bringing inflation down and delivering on its price-stability mandate. Nevertheless, this framework is to be reviewed in 2025, and while no drastic changes are needed, the author identifies here some areas for improvement.

The ECB's primary task, as defined by the 1992 Maastricht Treaty, is ensuring price stability in the euro area. The 2021 strategy review introduced a 2 percent symmetric target in the medium term. The author argues that this symmetric target is to be maintained and complemented with the ECB's emphasis on measures of underlying inflation and monitoring wages and mark-ups, as these measures filter out short-term volatility in headline inflation.

[2] First, banks are better capitalized and the industry more concentrated. Second, the high debt burden of the Euro Area. Third, the excess liquidity following negative rates. Fourth, the shift to non-bank financing. Fifth, the adjustment in house prices. Sixth, the persistence of weak growth and high uncertainty. And finally, the possible existence of non-linearities. As a result, the slowdown in credit has been more intense than predicted by historical standards.

The 2021 strategy emphasizes the need for forceful and persistent monetary policy response when the economy is close to the lower bound. Standard monetary theory calls for a differentiated policy response to inflation according to the nature of the shocks. And argues for greater patience in the face of negative supply shocks. However, patience does not mean inaction, and the ECB should respond actively to persistent supply shocks to prevent inflation expectations from de-anchoring, especially after long periods of low inflation. It is fair to say that the recent inflationary episode, despite being originally a supply shock, has surprised policy makers and markets alike for its magnitude and persistence, i.e. we have seen globally two digit inflation rates. Thus, the ECB's revised strategy should remind and emphasize the symmetry in the need for forceful action in both deflationary and inflationary contexts.

In the 2021 strategy, interest rates are considered the primary monetary policy instrument, with forward guidance, quantitative easing, and long-term refinancing operations also deemed appropriate. In terms of the toolkit at the disposal of central banks and the ECB, Hernández de Cos makes three points in this chapter: (i) interest rates have played a crucial role in the disinflation process, (ii) quantitative easing has proven useful in exigent circumstances, although the author does not comment on the relative merits of negative rates, and, (iii) quantitative tightening has had a smaller effects than the easing because of its gradual and predictable implementation. In other words, the significant reduction of the ECB balance sheet, around 30% from its peak, has not resulted in liquidity problems because the ECB has stuck to its preannounced schedule.

The monetary framework rests on voluntary reserves remaining large and ample at the endpoint of the quantitative tightening process. Thus, the deposit interest rate will remain as the key policy rate. It follows that the size of ECB payments to commercial banks in remuneration of their deposits at the central bank, is simply the necessary consequence of ECB policy. A deliberate outcome which has received much public attention and raised some undue political controversy. Were the monetary strategy to rely on daily auctions of liquidity, the so called MRO rate, the rate for the "main refinancing operations", will become the key policy rate, banks would not need to operate with abundant voluntary reserves and payments for them would not be substantial nor controversial.

The author makes an important political economy point that has arisen from the long period of QE. Obviously, monetary policy should be decided without any consideration to its impact on the potential losses of the Central Bank. Nevertheless, these losses and even more so potential additional capital contribution in case of need, may lead to political interference. A preferred approach could be to establish predefined rules for automatic recapitalization, an issue that is on the table in some significant central banks in the Eurozone. This legal provision would lift ex ante any potential external pressure and would also acknowledge that monetary and financial stability, as any other public good, may be costly especially in a digital world of declining seigniorage.

Under the current policy uncertainty, the ECB's strategy should be redesigned to guarantee robustness to different scenarios. Although the author recommends complementing the base line with alternative scenarios, he calls for caution in its publication, “not in a rigid manner”. The return of inflation and the foreseeable long lasting uncertainty about core economic policies, call for emphasizing robustness to various scenarios, not solely deflation. The new strategy will require an enlarged degree of flexibility to be capable of adapting to the origin, magnitude, and persistence of known and unknown shocks. Unconditional forward guidance should be avoided, and there might be a need to distinguish more clearly between quantitative easing for market functioning versus monetary stimulus.

Since mid-2021, the euro-area economy has faced high and persistent inflation, caused by exceptional shocks, including the COVID-19 pandemic, supply chain disruptions, the Russian invasion of Ukraine, an extraordinary loose global fiscal stance, and perhaps even the cost of maintaining the monetary impulse for too long. Forecasting inflation during this period has been challenging, with large positive errors observed until mid-2022. “Even after controlling for errors in technical assumptions, forecast error are positive and account for around 30% of total inflation errors in the period”, highlighting the need for improving forecasting tools. A deeper analysis of global an external shocks and how can they be incorporated into forecasting tools should also be a priority.

The ECB’s monetary policy response during the inflation surge was initially gradual but became more forceful as inflation persistence became clearer. The ECB’s actions ensured that inflation did not remain too far above the target for too long, preventing a de-anchoring of inflation expectations. The ECB’s forward guidance in 2021 delayed its response to the inflationary shock. But Hernández de Cos responds to the criticism that the EBC may have reacted too late by arguing that the timing of the tightening was not particularly relevant, given the forceful response after the first hike. And he describes in the text of the chapter, certain model simulations to that effect.

To conclude this chapter Hernández de Cos reminds the reader that monetary and fiscal policy are strongly interrelated, with coordinated responses crucial during crises. In that respect, the ECB’s transmission protection mechanism has helped stabilize markets and support the smooth transmission of monetary policy. But it is not a panaceas, and the ECB’s strategy should emphasize the need for sustainable fiscal policies as a precondition for a well-functioning European Monetary Union.

2.2. ENSURING FISCAL CAPACITY AND SUSTAINABILITY DESPITE STRUCTURAL PROBLEMS AT THE CORE.

To ensure fiscal stainability, the European Union adopted in April 2024 a new economic governance framework which was put in place for the first time this year. In Chapter 4, **Esther Gordo** studies *The Implementation of the revamped Fiscal Rules: Another missed opportunity for addressing the debt problem?*

The shortcomings of the preexisting fiscal framework were notorious, both from a purely functional and a democratic perspective. The new fiscal governance aims to address high public debt levels and the need for credible consolidation strategies amidst unprecedented investment needs due to demographic ageing, climate change, digital transformation, and geopolitical instability. A dual and conflictive objective that lies at the core of any fiscal policy, but that in a Monetary Union is particularly relevant. However, the new rules are based on the premise that fiscal sustainability, reforms and investments are mutually reinforcing and should be fostered as part of an integrated approach. As a result, it is not surprising that the rolling out of the new fiscal rules has been controversial and clearly unsatisfactory.

The new framework introduces a paradigm shift in fiscal surveillance, moving from annual deficit targets to multi-year expenditure paths anchored in debt sustainability analysis (DSA). It also aims to reconcile fiscal discipline with flexibility and national ownership. For a full analysis of the new rules see the Euro Yearbook 2024, "In conclusion, the new fiscal rules are a step forward in coordinating fiscal policy in the EU. But simplicity has been sacrificed on the altar of flexibility, and credibility remains to be seen".

As Esther Gordo writes in this chapter, challenges remain, including weak enforcement mechanisms, limited involvement of national parliaments and independent institutions, and the absence of a common fiscal capacity to finance public goods. The framework's ability to accommodate increased defense spending and other public investment needs remains limited, "raising fundamental questions about the efficiency and legitimacy of the current allocation of spending responsibilities between the EU and its Member states." We should thank the author for her courage in bringing the devil in the room to the forefront of our discussions, do we need a larger EU budget? If so, how will it be financed? Will it increase the overall tax pressure of Europeans? And what procedural changes do we need to keep a minimum of democratic legitimacy in the budgetary process? These are questions that need to be addressed explicitly, if the Union wants to make any real progress in the overwhelming academic demand for a common fiscal capacity. We have been dodging these real political issues for too long.

The reform also introduced: (i) a country-specific assessment of debt sustainability risks, (ii) a single operational variable (net primary expenditure), and (iii) escape clauses for exceptional circumstances. These changes aimed to provide a more realistic and transparent framework for fiscal policy, but significant practical and implementation challenges exist. The lack of ambition in its design and the immense public investment needs "risk exposing the framework to an existential test even before it becomes fully operational." The reliance on Debt Sustainability Analysis (DSA) presents methodological challenges, including risk assessment, the use of unobservable indicators, and the uniform application of fiscal multipliers. These challenges may affect the framework's effectiveness in ensuring long-term debt sustainability.

The new framework requires Member States to submit national medium-term fiscal structural plans (MTPs). However, the completeness and realism of these plans has varied greatly, with many national plans lacking detailed forecasts and assumptions. The involvement of national parliaments and Independent Fiscal Institutions (IFIs) in the preparation of MTPs has been limited, raising concerns about the quality and credibility of the plans. The role and capacity of national IFIs have not been significantly enhanced, and their involvement in the assessment of MTPs has been minimal. I would personally add to this chapter's institutional assessment the unsatisfactory role played by the European Commission. There is a growing consensus among external observers that it has been excessively understanding of local political considerations, thus raising concerns about the rationality and functionality of entrusting the Commission with the role of the gate keeper and enforcer.

As history may repeat itself, Esther Gordo also addresses the issue that Germany and France fiscal needs may conflict with the new rules. For instance, full utilization of Germany's reformed debt brake could result in public debt raising from 63% to over 100% of GDP by the late 2030s. In France, the IMF is projecting the debt ratio to increase to 120% of GDP by 2027. Proposals under consideration, proposals that will require changes in the fiscal framework, are: (i) the exclusion of approved infrastructure and defense expenditure from the rules, (ii) a revision of the Treaty's reference value of 60% to 90%, and (iii) the elimination of the deficit resilience safeguard, requiring a minimum annual reduction 0,25 percentage points in the primary fiscal deficit. Proposals that will only add to market doubts about the commitment to fiscal consolidation in the EU.

The new framework believes in incentives, additional public expenditure, to finance reforms that will increase potential output and eventually the tax base and thus, at long last, reduce the deficit. Carrots that come in lieu of sticks, sanctions, given that past experience has evidenced the absence of political will and legitimacy to imposes the existing penalties in the Union. In my view, although clearly not that of the author nor of the majority of European policy makers, this is a fundamental misconception, sheer wishful thinking, that lies at the basis of the implementation problems. The European Union has failed to address the historically high levels of public debt and has been constantly searching for arguments to avoid the necessary fiscal consolidation. Arguments that included the secular declining trend in the natural rate of interest and the irrelevant cost of deficit and debt, the digital and energy transitions, and now the immediate needs in defense, and ageing-related expenditures. Of course, all these arguments are valid. But the budget constrain remains, and the need to make room by reducing other public expenditure programs is evident, although silenced. Effective tax rates are already high in the Union, certainly in comparison with our competitors, and they are impacting on productivity and potential growth. The real European problem is not what additional room does the new fiscal framework allow for the deficit, as public discussion would lead us to believe, but how much are investors, both domestic and foreign, willing to finance and at what costs. As both the UK and the USA have recently uncomfortably discovered.

The economic and social problems in core countries of the Union are well known and could complicate the European outlook. Therefore, in chapter 5, **Isabelle Mateos y Lago** asks *Are France and Germany the sick men of Europe*? Despite remaining peerless and unchallenged in the EU in terms of dominant economic size and political clout, France and Germany have been facing economic, social and political challenges at least since the pandemic. They have both underperformed across several fronts since 2019. GDP growth, particularly in Germany, has been well below EU average. Poverty increased in both countries. Productivity growth has been particularly weak in France. Germany has suffered higher inflation, France higher unemployment. The growth potential of both countries has weakened markedly and is now estimated to be marginally above 1% in France and only around 0.5% in Germany.

But for Mateos y Lagos, France and Germany retain strong economic foundations and high living standards that should ensure their continued economic dominance within the EU. Roughly 50% in population of the EMU and over 1/3 of the EU, France and Germany dominate the European large corporate landscape, together accounting for 2/3 of the companies listed on the EUROSTOXX 50. They have large, healthy and well capitalized banking systems, particularly France, since in Germany, largely public, regional, and mutual banks dominate the domestic market and are less transparent although enjoy an implicit state guarantee.

Germany, is an outlier among the most advanced economies, having remained an industrial powerhouse and a dominant exporter of goods in recent decades. It has generated steady large current account surpluses, and at 18.3%, its employment share in manufacturing is the highest in the G7 (tied with Italy). True, France and Germany are both afflicted with adverse demographics, but this is a European problem.

Against this relative strengths, this chapter identifies three main challenges for Germany: (i) a high exposure to global trade shocks; (ii) an energy-intensive, medium-tech heavy economic structure, combined with a fossil-fuels heavy energy mix; and (iii) a depleted public capital stock. The German economy has historically been very dependent on exports and it also has a relatively high exposure to trade with the US, making it vulnerable to a tariff war. Germany suffered disproportionately from the energy price hike in 2022 because of its high dependence on fossil-fuels, particularly from Russia. The German economy relies heavily on energy-intensive industries and in the automobile sector “is in a league of its own”. Moreover, since the 1990s, public investment has been barely sufficient to offset depreciation. This is likely to have played a significant part in Germany’s weak productivity growth and decaying growth potential.

Mateos y Lago maintains that the winds have started to turn more favorable and more dramatic changes lie ahead. The 2022 terms of trade shock has largely been absorbed. The investment plan approved by the new governing coalition elected in March 2025, made possible by a constitutional reform of the “debt brake”, is set to be a game-changer. This plan provides for EUR 500 bn to be invested in infrastructure over the next 12 years, plus at least another EUR 500 bn in defense. She estimates that German GDP could be 1.5% higher by end 2029 and up to 2.5% higher by 2035. The potential inflationary effects are expected to be limited. And thanks to a relatively low initial debt to GDP ratio, and the productivity enhancing impact of the announced reforms, Germany should be able to finance this investment surge without meaningful crowding out effects, and limit the debt to GDP ratio to 70%.

Overall, an optimistic assessment of the German outlook based on political confidence on the new government, positive economic dynamics once the terms of trade energy shock has largely been absorbed, and strong implementation of broad and ambitious structural reforms. Because on current policies, the debt to GDP ratio would rise to about 100% of GDP in 10 years. There remains however a lingering doubt about the capacity of Germany to reinvent itself away from a sectoral specialization that is incompatible with its energy and climate policies. The question remains what will give in first.

France's economy has real structural strengths. Unlike Germany, France suffered severe de-industrialization in the last two decades, but what is left of it (17% of GDP, roughly 10 pp below 2000) is highly competitive and high value-added (luxury, pharma, aeronautics). Moreover, France has a strong and vibrant service sector, which reduces France's vulnerability to trade wars. France also benefits from low cost of energy thanks to early investment in nuclear power.

However, France's problems are mainly fiscal, hence technically easier but politically entrenched. France is the only large country in the EU that hasn't managed to rein in its public debt to GDP ratio or its fiscal deficit in the post-pandemic period. In fact, the deficit increased significantly in 2023 and 2024, due to a decline in tax revenue in terms of GDP and a public expenditure that remains above its pre-COVID level. As a result, the public debt to GDP ratio returned to its 2021 level (113% of GDP) in 2024, while it declined elsewhere in Europe. It is not obvious how France is to address fiscal consolidation in the current political impasse and with high taxation levels that already hurt potential growth. A particular challenge is that France's employment rate remains relatively low particularly among the youth and seniors, and it has a significant proportion of NEETs (not in education, employment or training).

But Mateos y Lago, believes fiscal consolidation albeit gradual has already started. The 2025 budget should reduce the deficit from 5.8% to 5.4% of GDP. To reach the government's target (3% of GDP in public deficit in 2029) an adjustment of 0.5 percentage points of GDP would be necessary per year, i.e. a primary effort of 1 percentage point of GDP per year (taking into account additional interest payments and military spending). Of course, there is always a risk that unforeseen factors could complicate this pace of consolidation. The country's track record in delivering pension reform is dismal and does not invite confidence. And French politics have been a complicating factor since last year's dissolution of Parliament. But Mateos y Lago argues that the seriousness of the problem should not be overestimated. Could we see a "Liz Truss moment" in France? No, since there is wide consensus across political forces, and public opinion, that fiscal consolidation is needed.

Finally, this chapter turns to the implications for Europe of the situation in its two larger economies. Bund yields have risen and are set to rise further as a result both of higher issuance volumes and higher growth expectations. While this trend will also affect other European countries, spreads with other member states should narrow slightly, particularly for those showing progress in consolidating their public finances. Spreads could be further contained by new recourse to joint borrowing alongside national one to finance defense efforts. Germany's rearmament carried out through a national initiative does not necessarily hinder the pursuit of joint projects at the European level. From the French perspective, the more European public goods can be financed at EU level, the easier it will be to reconcile its own fiscal consolidation needs with its undaunted aspiration to strengthen European sovereignty.

That said, it could be argued that a sovereign debt crisis in France would be seen to threaten the existence of the euro itself and as such might lead to capital outflows from the EZ at large. This is very much a gray swan in the author's view, and a far more likely scenario is that as the EZ's two largest economies regain health and dynamism, more global capital is drawn into the region, and the euro appreciates as a result.

2.3. FINANCIAL SUPERVISION AND REGULATION, INTERNATIONAL COMPETITIVENESS AND A LEVEL PLAYING FIELD.

The yearbook then moves to issues on financial regulation, focusing on two basic questions: simplification and harmonization of rules and developments in digital finance. In chapter 6, **Santiago Fernández de Lis** looks inside *The EU financial sector: competitiveness, simplicity and deregulation.* He begins by discussing the historical context of financial regulation, noting that regulatory cycles often follow financial crises. The current phase of regulatory tightening, fully understandable after the Great Financial Crisis of the late 2000s, has lasted over 15 years. As a side effect, it has resulted in a rechanneling of financial flows to non-bank financial intermediaries, including some segments that are little or not regulated at all, like private capital and crypto assets. It is still unclear if and when the new phase of deregulation will materialize. But it could easily be triggered by Trump's second presidency. At the same time, the EU is embarked in a simplification path in financial regulation, purposedly to enhance efficiency and economic growth. A point underlined in the Draghi and Letta reports, and which goes pari passu with the Savings and Investment Union, the new marketing name for the unsuccessful Capital Markets Union.

This chapter argues that fragmentation is probably the single most important factor in explaining EU banks underperformance, as compared to US banks, together with environmental and structural factors, but regulation also plays a role. After comparing financial regulation both sides of the Atlantic in different fields -prudential supervision, the approach to risk weighted assets, consumer protection, payments, privacy laws, cybersecurity, operational issues, and anti-money laundering - Fernández de Lis concludes that overall, "the EU regulation is probably harsher for banks", despite the Basel Committee considering the EU "materially noncompliant" while the USA is so far "largely compliant". But one should not forget that contrary to the EU, the US only applies Basel to very large, internationally active banks. Fragmentation and regulation result in no EU bank and five US banks in the list of the ten biggest banks in the world by market capitalization.

Complexity is embedded in the EU multi-layered governance system, which needs detailed and binding rules to prevent regulatory arbitrage from Member states inside the Single market. This chapter argues that the EU regulatory activism (especially in new fields) is mainly attributable to the EU Commission push to avoid inconsistent national regulations. This is so, because the EU feels the need to reign in national institution but has no direct authority over them. While the Banking Union required the creation of new institutions at the EU level, no national institution has been closed or discontinued, thus multiplying the possibilities of overlapping competencies and turf battles. Moreover, I would argue that most of these national institutions have increased in size, both in terms of budgetary allocations and staff, at a time when many of their core roles have been transferred to new EU institutions.

The EU strategy has consisted in setting up single purpose institutions, agencies with a single concrete task: microprudential, macroprudential, conduct, resolution, consumer protection, payments systems, deposit insurance… New regulatory and supervisory agencies with narrow mandates that often cross paths and compete in terms of orthodoxy and reporting requirements, thus creating uncertainty on the part of financial institutions. Furthermore, as these institutions are still in the process of establishing their credentials and scope of action, their actions tend to show a restrictive bias. This proliferation complicates coordination, creates uncertainty and multiplies compliance costs for supervised entities.

In the rethinking of the EU financial architecture, and in redrafting the mandate of some of these agencies, Fernández de Lis argues that the EU would benefit from an explicit inclusion of competitiveness objectives in the mandates of some agencies, in particular the Single Supervision Mechanism (SSM), in line with the recent UK reform, and from a strengthened accountability of the agencies. The line of argument is straight forward, competitiveness is a necessary condition for a solvent, solid, stable and sustainable financial system. Only a competitive financial system can also be stable.

In stressing the need for increasing accountability, Fernández de Lis drops the idea that "the SSM has inherited the independence of the ECB, in what is probably an excessive interpretation of the Treaty". And he adds, the rationale of extending this independence to banking supervisions is not obvious. Beyond its alleged weak legal foundation, on which I am not competent to comment, it seems to me that the independence of the Supervisor is particularly relevant. And for the same reasons and at the same conceptual level than monetary policy. The temptation to use supervisory practices for political gain is just as globally pervasive as the use of inflation. Evidence of politically induced banking crisis, of supervision looking sideways under instructions, of politically or friendly motivated credit bubbles resulting in stability problems, should be too close in our Spanish memory at least, to give up on strengthening the independence of supervisors. A different issue altogether, and one in which I fully concur with the author, is that accountability is the other side of independence. And it should lead independent monetary and financial agencies to stick strictly to its mandate and resist any temptation to overreach.

This chapter also discusses the EU's proactive approach to regulating new industries and technologies, such as the General Data Protection Regulation (GDPR) and the Digital Markets Act (DMA). It highlights concerns about the lack of European digital champions and suggests that excessive regulation may be a limiting factor, but causality may well run in the other direction, "the fact that the EU has fewer BigTech's may explain its more restrictive regulation and antitrust polices." A sort of size-regulation doom loop, a trap that enforces itself into a suboptimal equilibrium.

While this chapter welcomes the current EU simplification drive in financial regulation, it argues for greater ambition. It should extend beyond the current focus on the climate change area and simplification of SMEs reporting. To this effect, the impact analysis of regulations should be strengthened, putting more clearly the burden of the proof on the need to regulate. In this avenue, Fernández de Lis underlines certain trade-offs that need to be avoided: (i) less EU regulation should not be achieved in exchange for more national regulation, (ii) Less Level 1 regulation should not lead to more Level 2 regulation, and (iii) less regulation in exchange for more supervision is not a good idea since in the EU, supervision shows a more restrictive bias than regulation.

The chapter concludes with a list of specific proposals to streamline regulation, strengthen institutional accountability, and promote efficiency. I would not repeat them here, but I would encourage the interested reader to study them carefully in the chapter. They constitute an interesting roadmap for a more solid, stable and competitive European financial system.

Next, in chapter 7, **Rebecca Christie** puts regulation in international perspective and writes, *Basel under siege. Is the end in sight for global cooperation in financial rules?* She discusses the impact of U.S. President Donald Trump's policies on global financial cooperation, particularly focusing on the Basel capital standards. Since retaking office in 2025, Trump has taken several actions that challenge international cooperation, such as withdrawing from the World Health Organization and the Paris Agreement and considering pulling back from the World Bank and the IMF. Consequently, the concern about the future US role in international economic and financial coordination is running high. It would seem, however, judging from the last public speeches of secretary of Treasure Scott Bessent, that the current thinking has moved from abandoning these institutions to exert enormous pressures on them to pull back on its expansion and to force a significant retrenchment to its basic mandate. Will they do the same in Basel? And most importantly, because of competitiveness considerations, will that withdrawal lead to a worrisome race to the bottom in financial regulation? This chapter argues that the slow and technical nature of international financial architecture will help withstand major political pressures and avoid that major risk.

The result of long historical processes and many banking crisis, the international architecture for financial coordination is not straightforward. The Basel Committee on Banking Supervision, the Financial Stability Board and the Bank for International Settlements, each one with its own mandate, composition and institutional status, play a crucial role in setting and monitoring global banking standards. It is worth emphasizing that these standards are guidelines and not mandatory requirements. The so called Basel capital rules were originally agreed in the Basel Accord of 1988 and have suffered almost constant revisions. The original basic rule, the minimum capital ratio to risk-weighted assets of 8%, was set then.

Overtime the framework has evolved beyond credit risk to include market, counterparty and operational risks. Basel II introduced the concept of the three pillars, minimum capital requirements, supervisory review, and market discipline. It was also designed to apply only to large international active banks, the rest remaining subject to Basel I, to the simple 8% ratio. As of 2009, Basel 2.5 sought to prevent banks from moving troubled assets from their banking book to their trading book. As a result of the great financial crisis, Basel 3 was approved and the long road to implementation started. In essence, it calls for more and better capital and better liquidity management. It introduced concepts like the Countercyclical Buffer, the Leverage ratio, the Output floor, and the Net Stable Funding and Liquidity Coverage Ratio.

But Basel rules are not enforceable and need to be translated into national legislation. In this process, all major jurisdictions, and significantly the US and Europe, introduce their own qualifications, national priorities and political considerations. This is what makes comparing actual banking regulation so difficult, and transparency suffers, especially for non-listed banks.

In broad terms, EU and US capital requirements for banks are roughly equivalent. But they differ significantly once we adopt a more granular view of banks by size and business models. European regulatory demands are higher for small and medium size banks, as these banks' lending models are inherently less risky. But large and internationally European banks tend to face less requirements than their American counterparts, given their lesser specialization in investment banking activities. European banks are concerned about U.S. deregulation potentially putting them at a disadvantage, leading to calls for slower implementation of the next round of Basel rules, specially after the UK has decided to postpone its main component, the FRTB, the fundamental review of the trading book. The EU Commission has called for a postponement, but Rebecca Christie does not find any additional delay advisable.

In any case, bank capital itself does not move in lockstep with agreed rules. Market pressures, investors preferences, institutional goals and priorities, risk appetite, and supervisory expectations and moral authority, all influence the final outcome. In fact, European and American banks keep their capital and liquidity positions well above regulatory requirements. This so-called management buffer is a key indicator to assess the solvency of any institution, the state of the industry, and the stability of financial markets. And it would be appropriate to consider this buffer when modifying the rules. The increase in the mandatory capital buffer may only result in a reduction of the management buffer, in larger control by the regulator.

In closing, Christie argues that because banks have historically provided more than two thirds of European corporate financing, and regardless of whatever the Trump administration finally decides, European regulators have a big incentive to push ahead with full implementation of the Basel endgame without delay. In her rationale, if US banks were to face dramatically lower requirements, the global financial system would become riskier, thus giving EU regulators an additional argument. A proposition that totally ignores the previous calls for placing competitiveness at the heart of financial regulation, as the alert reader must have realized. Because this is in fact, an area of growing discussion and disagreement in Europe. In my view, as I already elaborated in the previous edition of the Yearbook, the time is ripe to pause the regulatory tsunami in banking, apply more decisively the proportionality criteria, focus on regulating non-banks financial intermediaries, NBFI, and foster the competitiveness of the European financial industry.

2.4. THE DIGITALIZATION OF FINANCES, PUBLIC AND PRIVATE DIGITAL ASSETS.

The last section of the Yearbook is about digital finances. In Chapter 8, Fernando **Navarrete** asks the question, *Do we really need the digital euro: a solution to what problem exactly?* He discusses the necessity, proportionality, and strategic coherence of the Digital Euro project within the broader context of the current geopolitical and financial landscape.

The Global Financial Crisis greatly damaged the credibility of money, banks and central banks and prompted monetary authorities to explore Central Bank Digital Currencies (CBDCs) as a means to regain public trust. But Navarete argues that a better strategy should concentrate on providing better policy outcomes from the fiat money and private financial intermediation system. His methodological approach lies on the basic economic concept of the opportunity costs.

This chapter emphasizes that while wholesale CBDCs can enhance the efficiency of wholesale payments and international transactions, retail CBDCs, like the proposed Digital Euro, pose significant risks to financial stability and privacy. Consequently, he favors the ECB to shift priorities and press decisively ahead with the exploration of wholesale CBCD initiatives. A development that does not need any complex institutional or legal shake-up as their development falls naturally within the traditional remit of Central Banks to provide back end payments infrastructure.

But the digital euro is a different animal, a new form of digital money issued by the ECB that represents a direct liability to its balance sheet, just like cash. The inherent physical inconvenience of cash has left the brunt of the store of value function of money to "commercial bank money", bank deposits. The modern digital nature of these bank accounts has made them the backbone of digital payments. Therefore, retail CBDCs are inherently destabilizing for the current banking ecosystem because of the potential erosion of its deposit base. This fact is precisely what some of the more radical proponents of a digital euro perceive as a plus. Those who would want CBs to hold all the liabilities of the financial system, and those who see it as an opportunity to return to a mystified world of private money. To prevent both unwanted consequences, the current digital euro proposal "imposes untested, unproven, and somewhat arbitrary exogeneous limitations in the form of how many digital euros any citizen can hold at any point in time." And Navarrete adds that it is essentially a political question whether these limits would hold in a crisis, whether they would prevent a large portion of the population seeking for a safe refuge for their savings. This politization of monetary instruments creates new risks to central bank independence.

The other consubstantial problem with retail CBDCs is their limited privacy compared to cash. And privacy is the foremost concern among EU citizens when considering a digital currency. The mere perception of surveillance erodes trust and may drive consumers back to informal or unregulated payment channels. This a political challenge. Data retention periods, access protocols, and oversight mechanism are not technical matters, but constitute societal choices that require democratic accountability, and transparent legislative mandates.

After reviewing risks in retail CBDCs, its potential costs, the chapter assesses potential benefits. Reducing CB anxiety about the erosion of seigniorage income, a silent levy, cannot be considered a benefit, since it certainly does not impact citizens welfare but only CB's profit and loss statements. Other, fairer, arguments to defend the digital euro have expanded well beyond the initial narrative to now include: (i) the secular reduction of the monetary base, the so called high powered money, with the declining use of cash which may lead to the loss of the monetary anchor and complicate monetary policy; (ii) digital sovereignty and strategic autonomy in the payment system; and (iii) the need to avoid monetary substitution due to the success of non-euro denominated stable coins. The underlying narrative has moved to more proactive ambition, create the European world of finance.

But Navarrete argues that the more problems the digital euro pretends to solve the less credible its claims. First, the declining relative prevalence of cash is at least a century old problem. Why is it now a problem? Is there a threshold that has been surpassed, a "tipping point"? If so, why only in Europe since no other major financial jurisdiction seems to be keen in developing its CBDC. The US Fed has abandoned the project well before the Trump administration, the UK, Australia and Canada as well. Only China, and for reasons that we would do better not to replicate, sticks to the original program.

Incidentally, the "unicity of money" is not only underpinned by the capacity to move commercial bank money into cash at par. It is fundamentally based on the capacity of every citizen to move their deposits at par from one bank to another. Reserves at the CB guarantee not just interbank settlements or the unicity of money, but also the capacity of the public monetary authority to steer monetary policy. A private ecosystem of innovative payment service providers, infrastructure developers, technical standards, etc. has emerged in recent decades. Should the Central Bank push back to reverse, stop or moderate this trend?

Second, with the Trump administration digital autonomy has come to the forefront of the European political debate. It is a fact that in the field of payments the EU remains structurally dependent on non-EU players. As in many other technological or security fields. A political consideration that Navarrete emphasizes, but which I find misguided. To put it bluntly, I fail to see why the Trump administration would want to intervene American Express or Visa to control Europe and not go all the way to manipulate Microsoft Windows or MacOS or IOS. In any case, as this chapter rightly argues, the root of EU vulnerability is not the absence of a digital euro, but the continued fragmentation of the European payments landscape. And for that to be remedied, other political initiatives seem much more promising and necessary.

Achieving payments autonomy may be more effectively pursued through a combination of regulatory clarity, support for European payments initiatives and the promotion of inter-operability and scale in private sector solutions based on commercial bank money. The goal should not be to replace existing global providers of payment services, but to complement them and be ready to substitute them if geopolitical risks materialize. Since private providers are not prioritizing offline solutions, a pure digital wallet, this is a niche where public intervention may be justified, and the ECB could implement.

Third, as for the risks of monetary substitution with the proliferation of crypto assets, the reality today is that stable coins serve mainly as platforms between the crypto world and the traditional fiat money financial system. And there are no indications that they are prepared to serve as full scale means of payments. If anything, they are becoming popular in countries where the population at large has lost confidence in the local currency, which is certainly not the case of the Euro area. They may be more of an alternative to dollarization, and therefore a potential problem in neighboring countries that may use them for euroization. This risk would only be exacerbated were the Euro Area to decide issuing digital euros.

A fourth and related final argument in favor of the digital euro is that it may increase the international role of the euro. An overplayed claim. Retail payments are only marginal drivers of international capital flows, which are mainly determined by the depth and liquidity of financial markets, the credibility of its institutions, political and military considerations, and sheer inertia.

Navarrete concludes his chapter underlining "the striking disconnect between the challenges identified by the ECB and the Commission and the capacity of the digital euro to effectively address them." Furthermore, the proposal raises critical concerns related to democratic legitimacy, market dynamics, the structure of financial intermediation, consumer protection and long term innovative capacity. It is a first order financial policy instrument that changes the way money is created, distributed and used. And incidentally, the minor issue of who bears the cost is unresolved. For these reasons, "the decision to issue a retail CBDC cannot rest within the Eurosystem alone". And not surprisingly given his current position he concludes, "Legislative co-decision by the European Parliament and the Council is essential."

A more balanced approach that leverages private-sector innovation and focuses on wholesale CBDCs may be more effective in achieving the desired outcomes. And Navarrete defines an alternative plan forward which I would urge the interested reader to study before jumping to any conclusion and being dragged in a popular digital euro wave.

The yearbook ends with **Carolina Albuerne** asking in chapter 9, whether *Regulating the rise in digital finance though DORA will open another transatlantic divide*. Since the Global Financial Crisis, the prudential requirements applicable to regulated institutions, particularly to banks, have sharply increased. In this context, the Digital Operational Resilience Act (DORA[3]) has been a new step ahead in expanding the extent and perimeter of prudential regulation to ICT risks. First, by harmonizing the standards on ICT risk management applicable to all EU financial entities. And second, by establishing a new prudential supervisory framework for certain "critical" ICT third-party service providers (TPSP), based on the extent and scope of their support for the critical or important functions of EU financial entities. Many rules set out by DORA were already in force through recommendations, guidelines and other standards for most financial entities. But their relevance comes from their binding nature, as they are set out by European regulation and, therefore, directly applicable to EU financial entities.

Authorities have issued standards on third-party risk management, with the overarching goal that the internal controls for outsourced activities are equivalent to those applied to non-outsourced activities by the regulated entity. The regulated entity remains accountable for the outsourced activities, and contracts with third parties must acknowledge the supervisor's ability to access the outsourced activity to maintain adherence to the same prudential oversight regime. It must be noted however that DORA's rules on third-party risk management only cover ICT services. DORA's rules are not directly applicable to other non-ICT third party services, that could be also very relevant in the business model of financial entities, including administrative, payment or other non-ICT services.

Financial entities are in principle free to decide whether to outsource or not their ICT services, including when the outsourcing affects or can affect the provision of critical or important services. They are "only" required to apply sound standards and procedures before agreeing to any ICT outsourcing. Financial entities should keep a comprehensive register of all their contractual arrangements with third party service providers for ICT services, distinguishing among those that support critical or important functions and those that do not. DORA is very demanding with the involvement of the financial entity's internal audit services in the review of ICT risks, and in ensuring access to the premises, information, and data managed by the service provider. It also requires financial entities to include in the contract clauses that require the TPSP to cooperate with the supervisor and the resolution authority, termination rights in favor of the financial entity, and those that thoroughly regulate the location where the service is provided and include rigorous provisions on data security.

The legislator is also aware that the concentration of the financial system in a few service providers can have systemic consequences. In response, the European Union has adopted a policy seeking to expand the prudential supervision perimeter beyond financial organizations, covering unregulated ICT TPSP. The regime is largely unprecedented, and it creates obligations for TPSP to submit information, surrender to onsite or offsite inspections and respond to the recommendations issued by the relevant Eu-

[3] Regulation (EU) 2022/2554 of the European Parliament and the Council of 14 December 2022 on digital operational resilience for the financial sector and amending regulations (EC) No 1060/2009, (EU) No 680/2014, (EU) No 909/2014, and (EU) 2016/2011.

ropean authorities. This framework goes well beyond the existent regime in the United States, where the Bank Services Companies Act (BCSA).[4]

After discussing the rationale of the DORA regime, Carolina Albuerne answers different questions of the new European regime: (i) which ICT TPSPs will be subject to the oversight regime?, (ii) who will be the lead supervisor of these entities?, (iii) which powers does the lead supervisor have?, and (iv) how should the powers over institutions that are based in third countries outside of the European Union be exercised?

Only service providers that can have a serious impact on the EU financial stability will be identified as critical, based on the following criteria: (i) the systemic impact on stability, continuity or quality in the provision of financial services if the ICT TPSP faces a large-scale operational failure; (ii) the systemic relevance of the financial entities relying on the services provided by the ICT TPSP, and (iii) the reliance on the TPSP by financial entities for performing their critical or important services. DORA requires ICT TPSP considered "critical" to have at least one subsidiary in the European Union to render services to EU financial entities.

The oversight framework does not require critical TPSP to be licensed, and therefore a third-party service provider does not need to undergo any authorization process before starting the provision of critical or important services to a financial entity in the European Union. Nor will its directors or senior managers be required to be subject to a fit and proper assessment. In other words, providing critical services to a regulated entity in the European Union is not a reserved activity, but it may trigger some prudential supervision. DORA gives the Lead Overseer information and inspection powers.

The authority will be able to conduct onsite inspections on any business premises of the service provider. The Lead Overseer will be assisted by a joint examination team to conduct inspections and other supervisory actions, in a structure that seems inspired by the Single Supervisory Mechanism's joint supervisory teams. DORA gives the Lead Overseer the power to issue requirements and recommendations on certain areas of activity of the critical ICT TPSP, and in the event of non-compliance, it may impose sanctions. The Lead Overseer may also issue recommendations to the critical service provider on refraining from entering into a further subcontracting agreement in cases where subcontracting may involve critical or important functions to the financial entities and the subcontracting party is located in a third country and the arrangement poses a clear and serious risk to the financial stability of the Union or to the served financial entities.

[4] There are material differences between the European (DORA) and American (BSCA) frameworks. First, the scope of BSCA covers only banks (not even all deposit-taking entities in the US), whereas DORA covers most financial institutions in the EU. The covered services by DORA are exclusively ICT, whereas BSCA's scope is broader, covering mainly all services rendered by third-parties to banks, including others such as payment or lending services. Second, a critical difference is that enforcement provisions are very clear in DORA, whereas in BSCA are lacking, what significantly weakens the position of the supervisors, and makes oversight dependent on an entity willingness to cooperate. Third, DORA includes provisions that ensure that the public can know which are the critical third-party service providers that are subject to the oversight regime, as they will be disclosed, whereas BSCA does not include any provision on disclosing these elements. Overall, DORA is a much more ambitious approach to a narrower universe than BSCA.

The recommendations issued by the Lead Overseer are not binding. Nonetheless, DORA contains different mechanisms of "moral suasion" and foresees that as a last resort, the competent authority (for instance, the banking supervisor for a bank) can force the financial entity to temporarily suspend or to terminate the use of the services of the ICT TPSP. This will be close to a "nuclear option" and may have huge business and reputational effects for the third-party service provider.

DORA also enables the Lead Overseer to exercise its powers (mainly information requirements and the power to conduct general investigations and inspections) outside of the European Union, on a subsidiarity basis when the objectives of the supervision regime cannot be achieved by applying them to the European subsidiary critical TPSP, for instance, if the TPSP manages or processes data in that country. It is not clear whether the critical TPSP and the relevant authorities in the third country would authorize an inspection or any other supervisory activity in the service provider's premises in that country.

The oversight framework set by DORA is new and unprecedented; and its main elements must be tested. For instance, the ESAs are yet to make the first designation of critical providers. Similarly, there are still unresolved issues regarding the organization of prudential supervision. In any event, European financial entities may have yet another source of regulatory costs that other international competitors -notably financial entities from the United States of America are not subject to. When it comes to the provision of ICT TPSP, EU financial entities will incur significant costs related to the amendment of contracts, the maintenance of a centralized register with all the data points for the covered contracts, etc. They may also face an increase in their operating costs, as TPSP may pass the costs of compliance through them. Depending on how ESAs decide to use their newly granted powers, EU financial entities may face higher costs linked to their operational models, that can affect their competitiveness in international markets and, in some cases, may also dent their ability to innovate.

3. CONCLUDING REMARKS AND TEN NEW LESSONS FOR EUROPE

Once again, this year, I will conclude my executive summary with ten lessons for the European Monetary Union. Lessons that summarize, in my own words, my interpretation of what the authors recommend in each one of the ten chapters of this book.

i. The European Union needs to make real the abstract concept of open strategic autonomy without falling into outright protectionism. It needs to preserve the special Atlantic relationship despite the current USA administration and to avoid and all out trade war. Unilateral trade liberalization is a preferred second best.

ii. Europe faces slower productivity growth due to lower investments in R&D and technology adoption and excessive regulation in goods, services and labor markets. Two structural trends will condition productivity and economic growth in the next decades, the development and adoption of technologies associated to robotics and artificial intelligence, and demographics. Europe lags behind in both accounts.

iii. The monetary policy framework adopted by the ECB in 2021 was instrumental in bringing inflation down. Nevertheless, this framework should be reviewed in 2025, by (i) emphasizing measures of underlying inflation and monitoring wages and mark-ups, as these indicators filter out short-term volatility in headline inflation; (ii) the symmetry in the need for forceful action in both deflationary and inflationary contexts; (iii) robustness to different scenarios, with improved communication of the alternative potential outcomes; and (iv) the need for sustainable fiscal policies as a precondition for a well-functioning European Monetary Union.

iv. The European Union has failed to address the historically high levels of public debt and has been searching for arguments to avoid the necessary fiscal consolidation. Recently, these arguments were the secular declining trend in the natural rate of interest and the irrelevant cost of deficit and debt, the digital and energy transitions, the immediate needs in defense, and ageing-related expenditures. Of course, all these arguments are valid. But the budget constrain remains, and the need to make room by reducing other public expenditure programs is evident. Effective tax rates are already high in the Union, and they impact productivity and potential growth. The European fiscal problem is not what additional room does the new fiscal framework allow for the deficit, as public discussion would lead us to believe, but how much are investors, both domestic and foreign, willing to finance and at what costs, in an uncertain and fractured world.

v. Germany faces three main economic challenges: (i) a high exposure to global trade shocks; (ii) an energy-intensive, medium-tech heavy economic structure, combined with a fossil-fuels heavy energy mix; and (iii) a depleted public capital stock. France is the only large country in the EU that hasn't managed to rein in its public debt to GDP ratio or its fiscal deficit in the post-pandemic period. His fiscal economic problems are technically easy but politically entrenched. The EU needs both countries politically stable and economically strong. The Union cannot survive without both of them functioning efficiently and leading the federalization drive.

vi. Excessive complexity is embedded in the EU multi-layered financial governance system, which needs detailed and binding rules to prevent regulatory arbitrage from Member states inside the Single market. Furthermore, while no national regulatory or supervisory institution has been dissolved, the EU has created multiple single purpose agencies: microprudential, macroprudential, conduct, resolution, consumer protection, payments systems, deposit insurance. This proliferation complicates coordination, creates uncertainty and multiplies compliance costs for supervised entities. In the rethinking of its financial architecture, and in redrafting the mandate of some of these agencies, the EU would benefit from an explicit inclusion of competitiveness objectives in their mandates and from putting more clearly the burden of the proof on the need to regulate.

vii. Although there is much concern about the future of international economic and financial coordination, it is likely that the slow and technical nature of international financial architecture will help it withstand major political pressures and avoid the risk of unilateralism in financial regulation. In any case, bank capital itself does not move in lockstep with agreed rules. Market pressures, investors preferences, institutional goals and priorities, risk appetite, and supervisory expectations and moral authority, all influence the final outcome. Therefore, regardless of Trump's decisions, it is unlikely that a race to the bottom in financial regulation may actually occur, but EU policy makers should nurture a level playing field.

viii. The digital euro raises raises critical concerns related to democratic legitimacy, market dynamics, the structure of financial intermediation, consumer protection and long term innovative capacity. Retail CBDCs are inherently destabilizing for the current banking ecosystem because of the potential erosion of its deposit base. The other consubstantial problem with retail CBDCs is their reduce privacy compared to cash. Potential benefits include preserving seigniorage, a silent and hidden levy, avoiding the potential loss of the monetary anchor, digital sovereignty and strategic autonomy in the payment system; and preventing monetary substitution to non-euro denominated stable coins. There is a however, a striking disconnect between the challenges identified by the ECB and the Commission and the capacity of the digital euro to address them. A more balanced approach that leverages private-sector innovation and focuses on wholesale CBDCs may be more effective in achieving the desired outcomes. The Digital Euro project, as currently proposed, may not be the optimal solution for addressing these challenges.

ix. The scope of application of DORA is very broad, as its main goal is to harmonize the standards for management ICT risks across the financial system. The oversight framework set by DORA is new and unprecedented; and its main elements must be tested. There are still unresolved issues regarding the organization of prudential supervision. In any case, European financial entities may have yet another source of regulatory costs that other international competitors notably financial entities from the USA, are not subject to. When it comes to the provision of ICT TPSP, EU financial entities will incur significant costs related to the amendment of contracts, the maintenance of a centralized register with all the data points for the covered contracts, etc. They may also face an increase in their operating costs.

x. As a final and personal note, current events demonstrate that in a fractured world, the European Union is more needed than ever. It is real time proof that political and economic cooperation benefits all participants and promotes social and economic development. But the challenges ahead are significant and the EU would need to adapt by changing its decision making processes, redrafting the distribution of competencies between the Union, federal institutions, and national governments and moving forward in the transfer of sovereignty in certain areas, with the view of eventually arriving at a new Treaty.