

The European Banking Union: Will It Be a True Union without Risk Sharing?

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1. Introduction

I played a minor role in the initial gestation of the Maastricht Treaty as a representative of the Italian Treasury (Dyson and Featherstone, 1999), which ended with my transitioning in early 1991 to the newly established European Bank for Reconstruction and Development (EBRD). My concerns during the period in which I participated in the negotiations had to do more with the economic part of the planned union rather than the monetary one. This was because, first of all, this latter part had been the main result of the *Delors Report* of 1989-1990, approved by the governors of all twelve participating central banks, and of which the late Tommaso Padoa-Schioppa was rapporteur.¹ Secondly, it was because the economic part had not been the subject of any similarly innovative proposals (Sarcinelli, 2009). Thus, even though the Maastricht Treaty speaks of an Economic and Monetary Union (EMU), in reality only a European monetary union was born, which became operational in 1999.

As I noted in a study in which I commented on the Commission's report for the tenth birthday of the euro (European Commission – DGEFA, 2008), the unbalanced structure of the EMU did not prevent it from achieving considerable success on the monetary front, unexpected by some,² albeit within a favourable environment. In the United States, until the recent crisis, this was referred to as the 'Great Moderation,' with critics of the euro considering it to be a 'fair-weather currency.' In fact,

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¹ His previous effort is also noteworthy: Padoa-Schioppa (1987).

² On the scepticism and incredulity prevalent among American economists see Jonung and Drea (2009).

with the harnessing of public finances, the dreaded *asymmetric shocks* from public demand, with the exceptions of Greece and Portugal, gave way to those from private demand, particularly in the real estate sectors of Ireland and Spain, and especially to those common to the whole area. These were due to fluctuations in the exchange rate, alternations in the prices of commodities and energy, and shifting comparative advantages. In addition, monetary management was able to anchor inflationary expectations, preserving the purchasing power of the new currency, even though consumers have often, and especially at the time of the 'changeover,' perceived inflation to be higher than has been statistically recorded. The size of the area in which the euro became legal tender, which has grown from eleven initial States to now include seventeen members, has ultimately contributed to spreading and to strengthening its use as a currency in which to issue invoices, make payments, denominate financial assets and accumulate reserves (Bini Smaghi, 2008, pp. 77).

Even though financial globalisation was not explicitly included among the challenges listed in the report, its dangers were perceptible enough. The document stated that it seemed "[...] to have increased the potential for large-scale financial crisis, with major breaks in the growth process" (European Commission – DGEFA, 2008, p. 162). Moreover, the intra-European dimension of globalisation was clearly present. In fact, the link between the single currency and the integration of financial markets was recognised as fundamental and pervasive. In a currency area formed by several states, in the absence of an exchange rate and even, in the case of the Eurozone, of a substantial fiscal power at the central level, the adjustment must proceed through the flow of factors and/or changes in their prices.³ The burden thus falls on labour and capital. The former, however, is characterised by a rather downwardly rigid level of salaries, and by testing conditions as regards internal migration (linguistic and social barriers, portability of social rights, etc.). By contrast, the latter, and in particular financial capital:

a) is highly mobile;

³ On OCA (optimum currency area) adjustment mechanisms in general and those of the EMU in recent years see Mundell (1961), McKinnon (1963), Kenen (1969), Krugman (1993), Frankel and Rose (1997; 1998), Byoumi and Eichengreen (1999).

- b) allows for the sharing of risk;
- c) allows for the inter-temporal reallocation of consumption, which is essential where the size and role of the federal or common budget does not allow for a compensating function;
- d) makes monetary policy more effective, improving transmission mechanisms;
- e) reduces the role of fiscal policy as a stabilisation tool, due to the integration of markets and the greater likelihood of supply shocks, which are of preference to be entrusted to the care of the market, and not of discretionary fiscal policy;
- f) encourages structural reforms, making funds flow to where they are most productive: in a currency area in which exchange rate risk no longer exists, the preference for domestic bond issuers decreases, and imbalances in the balance of payments are no longer perceived until... they are no longer financeable!⁴

Despite all these theoretical premises, in reality the single currency and the related freedom in the movement of capital do not avoid inconsistent developments and at times can even hide them. Moreover, the single currency does not protect against contagion coming from abroad. The financial crisis that erupted in the United States, in 2007, which was made especially evident by the bankruptcy of Lehman Brothers the following year, spread to Europe. In doing so it brought about a severe recession, especially in the southern States of the Union, and triggered tensions around sovereign debts that had increased due to bank bailouts, as was the case in Ireland and Spain, or that were already high due to the imprudent management of public finances, as in Italy and Portugal. This is not to mention Greece where, in addition to the common ailments of other countries, there was a conscious mendacity regarding the state of public finances. So far, with the exception of Italy, all the abovementioned countries have resorted to the Eurozone and the European Union for financial aid. The latest country to be hit by a crisis that required the community's intervention was Cyprus, to which we

⁴ On the imbalances in the balance of payments in the Eurozone, see Alessandrini *et al.* (2012), Cesaratto (2012).

shall now turn our attention.

The difficulties that struck the Mediterranean island have been due in part to its being a sort of off-shore centre not above suspicion, within the Eurozone, with banking growth clearly disproportionate to the size of the island's economy. This, as in the case of Iceland, made it impossible for the State to bail out its two largest banks. The difficulties are also due to the investment of funds by these banks in Greek bonds that were wiped out by the 'bail-in' enacted to save Greece from bankruptcy and keep it, at the cost of great sacrifices for its inhabitants, within the Eurozone. International aid to rescue Cyprus from insolvency, as in the case of Greece, was made conditional on private sector involvement. Although the IMF had recommended, it would seem, the safeguarding of insured depositors (i.e. those with balances of up to €100,000 according to the European rule), and to impose a contribution on bondholders and depositors with higher balances, the proposal sent to, and duly rejected by the Cypriot parliament even included a taxation on guaranteed deposits! With a second attempt, only the large depositors for the uninsured part were made to contribute, to an extent to be determined on the basis of the total amount the 'troika' (the European Commission, ECB and IMF) decided should be raised by the Cypriot economy. This solution led to the introduction of capital movement controls, breaking – hopefully only for a short time – the unity of the monetary area, which does not seem to comply with Article 65(3) of the Treaty on the Functioning of the European Union (TFEU), as argued by Darvas and Wolff (2013). Evidently, this is quite a mess. On the one hand, it does not reveal clear or coherent thinking on the part of either the Eurozone finance ministers or the European Commission (Bruton, 2013). On the other hand, it is the consequence of decisions made on private sector involvement in the previous Greek bailout...

It is time, therefore, to look reality in the face and strengthen the structures of the EMU. The remainder of this article is devoted to what has been done and what must still be done to make the European banking system more robust and less permeable to crises, and to preserve the single financial market. In the following sections we look at the initiatives of both the European Commission and the European Council to

complete the EMU by creating a banking union (section 2), the doubts on the wisdom of entrusting banking oversight to the ECB (section 3), the organization of the ECB's new tasks (section 4), the continuing absence of facilities for the recovery or liquidation of banks, as well as for a Euro-wide deposit insurance (section 5), the need for some form of risk-sharing in order to stabilise the economy (section 6), and thus the recourse to a common budget and the possibility of joint debt for the Eurozone (section 7).

2. The European Commission and Council on the completion of EMU

It is the very inflow of funds due to the disappearance of exchange rate risk, the insensitivity to the trends of the balances of payments and the diversification of investments across multiple countries in the Eurozone (in particular across those with higher nominal interest rates), that has given rise to the problems of recent years. After several interventions aimed at coordinating economic and fiscal policies more closely, especially within the Eurozone,⁵ in May 2012 in order to restore confidence in banks and in the euro, the European Commission's President Barroso launched the idea of a banking union, characterised by a Single Supervisory Mechanism (SSM) able to supervise banks, to uniformly apply prudential rules and to exercise supervision over cross-border banking markets. Later on, the Commission and President Van Rompuy proposed and obtained the European Council's approval to strengthen the Eurozone through the creation of a banking union, one also open to member States that have not adopted the euro as their currency.

On June 28-29th the European Council (European Council, 2012a) gave Van Rompuy a mandate, assisted by the other presidents and in the light of their first *Report*, to formulate proposals and timelines for such a mechanism by December. Direct recapitalisation of the troubled Eurozone banks by the newly formed ESM (European Stability Mechanism) was made contingent on the establishment of the SSM.

⁵ For a general overview of the measures taken to strengthen cooperation see Sarcinelli (2013a).

Recapitalisation was an insistent request made by Spain in order to avoid pushing up its public debt, as had previously happened to Ireland. It is also a way, however, to shift the tax liability of bank bailouts from the national to the European level: a goal for the weak and indebted countries, a calamity for the more 'virtuous' ones.

In implementing previously expressed intentions, the Commission's proposal (European Commission, 2012a), made official on September 12th, was to enable the ECB, on the basis of Article 127(6) of the TFEU, with specific tasks concerning policies relating to the prudential supervision of credit institutions, with the exception of insurance companies. This possibility was already foreseen by the ECB's own Statute. For conglomerates that include insurance companies, the ECB's jurisdiction will be at the consolidated level. National authorities will have jurisdiction over individual companies, as well as over consumer protection, money laundering, etc.

When sending the action plan to the Council and the Parliament, the Commission asked them to reach an agreement by the end of 2012 on its proposals for a CRD IV (Capital Requirements Directive IV) and deposit guarantee schemes, as well as a proposal for the recovery and liquidation of banks. For the allocation of specific supervisory tasks to the ECB, the Commission proposed a Council regulation, but the Parliament initially objected that in this way it would have been deprived of the right to co-decide, and noted that the timeframe recommended by the Commission was completely unrealistic. Unfortunately, these EU institutions continue to specify impossible objectives, given their working methods. They do not seem to comprehend that in doing so they are destroying their own credibility.

Taking note of the *Interim Report* of the four presidents, on October 18th the European Council (European Council, 2012b) indicated that a more complete banking and monetary union must be based on the institutional and legal framework of the EU, respect for the integrity of the single market and full transparency in relation to non-euro countries. At that meeting a compromise between Germany, which had placed an emphasis on the quality rather than the speed of the devolution, and France, Italy and Spain, which had insisted on the commitments made in

June, was reached. The transfer of powers would take place in 2013 – a target later shifted to 2014 – but by the end of 2012 the legislative framework, including the harmonization of national systems, must be completed for the recovery and liquidation of banks and financial companies (European Commission, 2012b), as well as deposit insurance, to be based on the Commission’s legislative proposals on these issues. Following their approval, the Commission has already announced that it will propose a single liquidation mechanism for all countries participating in the SSM. To launch a European debate, in late November 2012 the Commission issued a communication concerning the deepening of the EMU (European Commission, 2012c).

On the basis of the *Final Report* by Van Rompuy and the other presidents, at its meeting on December 13-14th the Council (European Council, 2012c) accepted the roadmap for the completion of the EMU, marked by greater integration and solidarity. The process initially involves the strengthening of economic governance, the adoption of the SSM and finally new rules on the recovery and liquidation/resolution of banks, as well as deposit insurance. However, the measures for which approval was sought by the end of the year continue to be urgently required, but not yet enacted. The direct recapitalization of banks has been postponed until not only the introduction of an effective SSM, but also the formulation of its operating rules, including the definition of ‘legacy assets.’ Regarding the solidarity mechanisms that may reward the efforts of the member States that are contractually obliged to improve competitiveness and growth, they will have to wait for further compromises to be agreed, which will also cover other topics to be presented at the Council in June 2013. There is no mention at all of the fiscal capacity as such. It took twenty years and a particularly serious crisis to recognise that the EMU envisaged by the Maastricht Treaty was a draft that needed to be completed, a “bare-bones union” according to Pisani-Ferry (2012), yet the speed at which progress is being made in strengthening it is still slow, very slow.

3. Doubts on the supervision entrusted to the ECB

The attribution of unified banking supervision powers to the ECB raises, in my opinion, several problems of coexistence with other institutions, both national and European.⁶

- a) The first problem arises with the Eurozone's national supervision authorities, which will continue to carry out 'routine' inspections and other activities for the preparation and implementation of the ECB's decisions. However, this way they will be acting as integral parts of the SSM, hopefully from a 'federal' standpoint, as I argued over ten years ago (Sarcinelli, 2002). Since the severity of the current crisis can in large part be traced back to a lack of supervision and to excessive forbearance on the part of many supervisors, today's trend is in favour of greater centralization. However, we must not forget that although the ECB can take on full responsibility, in any case it will necessarily have to delegate its tasks. This is because, if elephantiasis is to be prevented, it will not be able to directly oversee the more than 6,000 institutions scattered over its vast territory. Of course, the delegation of activities will be bound by rules and standards, and the ECB will retain the power to decide on a case-by-case basis.⁷
- b) A second and probably more serious problem regarding coexistence arises with the supervisory authorities of the non-EMU countries, which may, but certainly will not be obliged to, sign an agreement of cooperation with the ECB and be represented in the supervisory council to come. It is difficult to imagine that there is one single scheme that the ECB can develop, to which the States that have not adopted the euro will adhere. The diversity of situations and the innate tendency of

⁶ Sections 3 and 4 draw on my communications at the XII Forum for Hispanic-Italian Dialogue held in Madrid on October 29-30, 2012, published in *AREL la rivista*, n. 3, 2012 and *Banca, Impresa e Società*, n. 3, 2012.

⁷ With the aforementioned limitations to its mandate, the so-called Meroni doctrine, imposed by the Court of Justice in 1958 and according to which community institutions are prohibited from delegating powers that imply the exercise of discretion, seems likely to be overcome; see Bernardi (2012).

States not to budge on their specificity in order to receive differential treatment will result in several different agreements. If this is to be the case, the management of the supervision will be more complex and difficult. In addition, with respect to the countries outside the Eurozone, the implementation of supervision must necessarily be delegated to national authorities. However, it is believed (Darvas and Wolff, 2013b) that despite the weak legal basis for the involvement of countries from outside the Eurozone, each of them would be sufficiently protected by the regulation to be approved which provides for the opportunity to exit the SSM in the case a State disagrees with a proposal formulated by the supervisory board and approved by the Executive Board of the ECB. The price of this freedom to exit is the uncertainty regarding the geographical stability over time of the supervisory network under the central bank's control.

- c) Finally, a third issue regarding coexistence arises with the European Banking Authority (EBA), which has powers of supervision and responsibility over the entire EU. The EBA, based in London, will remain entrusted with drafting the 'single rulebook,'⁸ as well as with favouring the convergence and consistency of banking practices. Overcoming the prejudices and fears of the members of the Union that have not chosen the euro as their currency is a necessity in order to preserve the coherence of the single market.⁹ Since the weight of the Eurozone countries, who are required to coordinate, could reduce the representation of other countries, in the election of the EBA's management committee two posts will be reserved for the latter. However, since banks' operative practices are influenced by the supervisors, a field in which the ECB will have a predominant role, the task of the EBA to avoid fragmentation of the single market risks becoming almost impossible. In addition, the supervisory activities of the ECB and the delegated national

⁸ Strongly sought after by Padoa-Schioppa (2007).

⁹ On this point see Dullien (2012) and IMF Staff (2013), which indeed covers the whole issue of a European banking union.

bodies may indicate the need to introduce new rules or modify those already contained in the ‘single rulebook,’ with the possibility for collaboration as well as conflict between the two European authorities.

4. The ECB’s organization of supervisory activities

In 1992, just as the ink of the signatures on the Maastricht Treaty dried, I wrote about the new monetary institution’s possible supervisory tasks (Sarcinelli, 1992, p. 164):

“Although the statutory function [...] with reference to banking supervision is minimal, the merits of *centralizing supervision in the hands of a specialized agency with responsibility for the entire territory of the Community* should be carefully examined, because, while the activity is globalizing, supervisory responsibilities risk remaining fragmented and creating externalities to the detriment of this or that national supervisory system” (italics added).

Since then, I have repeated this belief countless times.¹⁰

Unfortunately, more often than not institutional innovations come about as the result of an urgency to react. Thus, rather than being the work of some genius architect, the European construction seems to be more and more like an ancient city, one whose original fabric has altered over time according to changing needs, architectural styles, and political and economic developments. In 2012 the crisis, originated in finance and produced serious real developments, induced the authorities of the European Union and especially those of the Eurozone to move at an accelerated pace on the issue of supervision. The presence of a single currency can be not only destabilizing, if the financial difficulties of a member State spread to the rest of the area, but also it does not avoid the risk of segmentation along national borders of the single market for financial services.

If the institutional architecture was not the consequence of contingencies and above all of the (providential?) presence of Article

¹⁰ Among the many reaffirmations, see Sarcinelli (2004).

127(6) of the TFEU, would not it be better to have a single European agency that is responsible for both financial regulation and supervision, one that is distinct from the ECB? After all, scholars justify the involvement of the central bank in supervision limited to macro-prudential aspects only.¹¹ For micro-prudential aspects they point out that, if on the one hand it allows to know the situation of the intermediary on an ongoing basis, and thus facilitates lending of last resort, on the other hand it is also a source of potential conflicts of interest. Today the ECB is fully involved in macro-prudential oversight through the European Systemic Risk Board, and has a lender-of-last-resort function, although only for intermediaries and ‘overnight’ operations. Therefore, banking supervision could have found a better home elsewhere. A few years ago, in justifying the maintenance of supervisory functions on the part of the central banks within the Eurozone, the ECB itself wrote in a document:

“The introduction of the euro has implied an institutional separation of monetary jurisdiction (the euro area) and supervisory jurisdiction (domestic institutions and markets). Hence, the NCBs no longer have any independent control over money creation” (European Central Bank, 2001, p. 8).

And now that it is proposed that the ECB be entrusted with banking supervision as well, how can it reconcile that supervisory role coexist with its monetary function? Through an elaborate organisational separation. In order to enact supervision, the ECB will have to structure itself into two separate areas, one for monetary policy tasks, which will continue to be carried out with full independence, and the other for supervision. This is not only to avoid possible conflicts of interest, but also to emphasise that for the former function it does not have to answer to other authorities, while for the latter it will be accountable to the European Parliament and Council on the proportionate and effective use of its powers. There will be a supervisory board, but decisions will necessarily have to be made by the Governing Council of the central bank. After the conferral of powers, the ECB may exercise supervision

¹¹ On the optimal character of micro-prudential oversight on the part of an entity other than the central bank, when there is a risk that the supervisor is captured by bankers, see Boyer and Ponce (2010).

over any bank, and in particular those that have received public assistance.

The ECB's response to this increase in its duties and responsibilities has been favourable. On the other hand, it had already been suggested by Duisenberg, albeit on a personal basis, and Trichet. Draghi said that when it was decided to assign banking supervision to the ECB, only two conditions were raised: that the ECB can operate without incurring reputational risks, and that oversight is separated from politics. It is worth mentioning that the high level group chaired by de Larosière (2009) offered six arguments against this solution,¹² which was also greeted unfavourably by the economic advisors to the German government (German Council of Economic Experts – GCEE, 2012).¹³

Finally, one cannot fail to mention that the stability of the European banking system and the effectiveness of oversight would be facilitated by the segmentation between deposit or commercial banks and investment banks (Sarcinelli, 2012; 2010), proposed by Volcker in the United States,¹⁴ by the Independent Commission on Banking or ICB (2011) in the UK, and by the Liikanen Report (2012) for the European Union. The latter has much in common with its English counterpart, both in terms of economic justification and in terms of regulatory provisions.¹⁵ Beyond a certain threshold, banks engaged in trading must carry out such activity within a separate legal structure from the retail bank, though with an operational area that does not always coincide with that outlined by the ICB. Both units could be part of the same holding company, but each would have its own capital. The entity dedicated to trading would be inhibited from acquiring guaranteed deposits and offering payment services. Thus, the Liikanen Report also refers to a kind of ring-fencing. However, as opposed to its British counterpart, it is set in a flexible way. It also provides the option for regulators to expand the perimeter of the protected area, if this is necessary to ensure the possibility of resolution

¹² See also Ruding (2012).

¹³ On the GCEE's position on the various modules of the banking union (supervision, recovery/liquidation of banks, deposit insurance), see Sarcinelli (2013b).

¹⁴ See Sweet and Christiansen (2011).

¹⁵ See Vickers (2012).

of the bank and the continuing supply of basic services. In addition, the report ordered by Commissioner Barnier recommends increasing the ability of banks to absorb losses through an expansion of the debt bail-in, and a better definition of the weighting of risks in capital requirements. Finally, it suggests strengthening banks' governance.

While the European Commission has not yet submitted its proposals in light of the Liikanen Report, France and Germany are changing their banking laws to take into account, to some extent, the recommendations contained therein. But they are doing so in a non-homogeneous way, thus exacerbating the disparity between the structural designs of the different banking systems...

5. Bank recovery and liquidation, and deposit insurance

The SSM, intended to function as a network, and the ECB, vested with the powers of supervision over the banking system, can most certainly facilitate the functioning of the single financial market, ensuring a more level playing field through greater organizational uniformity and a more homogeneous management of supervision. Nevertheless, they are not able to entirely prevent one or more credit institutions from falling into distress due to management errors, contagion from institutions based outside the EU or the Eurozone, or adverse industrial or local circumstances. When these risks are considered, it seems strange that the ECB would want to take on the responsibility of oversight for banks and banking groups that make up at least half of the banking system of the Eurozone. In the case that a multinational banking group were to fall into difficulties such as to require restructuring, the ECB would find itself discussing and seeking solutions with an array of national institutions, each with unequal powers and subject to different constraints, inclined to defend national interests more than those of the community. Will caution push to delay the start of centralised oversight until the legislation proposed by the Commission on the recovery and resolution of banks comes into effect? Anyway, the German finance minister, Schäuble, is against the single resolution mechanism proposed by the European

Commission unless the Treaties are amended...

To this aim, on June 6th 2012, proposals to address this issue were handed down to European legislators (European Commission, 2012b), with the aim of avoiding contagion effects in any future financial crisis, and in particular those that are detrimental to depositors and taxpayers. The Commission proposed a common framework of rules and powers in order to ensure financial stability, while bank shareholders and creditors are called upon to fully bear their share of losses and costs for recapitalization. This should help to both avert crises and manage them in an orderly way and with greater efficiency, wherever they might happen to manifest themselves. Member States are required to establish an *ex ante* fund for liquidations, that is to impose contributions on banks to be accumulated up to 1% of guaranteed deposits, plus another potential contribution to be paid *ex post*. In addition, in cases of necessity, there is the possibility to activate a compulsory loan between the national funds, subject of course to well-defined limits.

The rules call for a uniform application throughout the European Union. A crucial role in achieving this goal has been given to the EBA, with the use of the powers and means conferred to it by the regulation that established it (prosecution of violations of Union law, mediation, obligatory technical standards, guidelines and recommendations). Thus, the EBA has been given the task of building a legal framework and a culture of supervision that works for the entire EU, which implies uniformity in oversight practice. Therefore, the *single rulebook* must find a companion in a *single supervisory handbook*. If the task of the EBA already seemed to be considerably difficult before, this additional responsibility of promoting a common legal system that is able to allow the construction of a single supervision manual seems to me to belong to the realm of fantasy.

The basic idea behind the legislation proposed by the Commission is that quick and timely intervention is necessary at the onset of difficulties. Banks will thus be forced to prepare recovery plans for an emergency, validated by the oversight authorities. In the past, I expressed a negative opinion on 'living wills,' which the United States and the G20 rely on, and which are most certainly unable to reduce systemic risk. I have even

less confidence in these plans for emergencies, since it is not *a priori* known through which channel and to what degree such emergencies might manifest themselves. In an influential French newspaper the following passage was written: “Given that BNP Paribas’ last will is already 1,800 pages long, will it be of any use when the decision whether or not to save a company with a balance sheet the size of the French GDP must be made in 48 hours?” (Giraud, 2013, our translation). In turn, the resolution authority will have to prepare appropriate plans. For each institution? For groups of institutions? To be updated at what rate, and depending on what factors of crisis? Once again, it seems to me that there is a desire to foresee the unforeseeable, to draw up recovery and treatment plans in the hospital for the potential patient, while in complete ignorance to the syndrome or disease that could strike him! For cross-border groups, commissions of resolution authorities will be established under the guidance of the country in which the parent company is based and with the participation of the EBA, which will be able to make use of its power of binding mediation.

The public interest, i.e. the consequences in terms of financial stability, will be the factor in choosing between liquidation or resolution. The latter can take on four forms: partial sale of the bank; creation of a bridge-bank, through nationalization and its subsequent reprivatization; the separation of assets and liabilities between a good bank and a bad bank; ‘bail-in,’ that is a call on the bondholders to bear the losses through the transformation of loans into equity or the curtailment of their nominal value. Giving this power to the authorities responsible for resolution would mean authoritatively infringing on credit rights, which would risk impacting negatively on the cost of banks funding through bonds, and shifting the demand for bonds to collateralised ones. The directive, if approved in time, would enter into force at the beginning of 2015 and the bail-in three years later.

And what about deposit insurance? The directive proposal discussed above says that individual member States may decide to merge the fund for resolution with that for deposit insurance, or to keep them separate. In the case of interventions in a multinational group, the lack of homogeneity between the funds could create problems, since forms of

financial burden sharing are foreseen in resolution operations (Bernardi, 2012).

The issue of deposit insurance has long been the subject of the Community's attention. By the end of 2010 the coverage of national deposit insurance schemes was raised to €100,000 per depositor per institution. The previous June, the European Commission (2010) proposed accelerating reimbursement times and forcing member states to have pre-funded or *ex ante* funds only, obviously financed by the banks and obliged to reciprocally lend themselves credit, within limits. Due to differences of opinion between the Council and the Parliament, the directive remains mired; if it were to be approved as is currently written, European banks based in Austria, Italy, United Kingdom, etc. and participating in *ex post* funds would be heavily penalised, unless they were authorised to include a specific entry in their financial statements that is guaranteed by government bonds.

Cannot be there a single body, at the European level, for deposit insurance and the resolution of troubled banks? The answer is certainly yes and the FDIC (Federal Deposit Insurance Corporation) in the USA is well-known example of such; also in Japan the two functions are entrusted to the same entity. Adopting this scheme in Europe as well would mean centralizing functions that today are present at the national level with a high degree of heterogeneity (Allen *et al.*, 2011; Gerhardt and Lannoo, 2011). The Commission's proposals discussed above still seem to be based more on the home country principle and the harmonization of funds and procedures that fundamentally remain national. In contrast, the ECB has supported the need for a European authority for resolution in the Eurozone,¹⁶ whose jurisdiction may be expanded at a later time to include the rest of the EU, as well as a single deposit insurance scheme for the whole area.¹⁷ Rapid decision-making is probably the biggest advantage of such a structure, together with a unanimous assessment on the opportunity to repay depositors and allowing a bank to fail, or instead to try to save it. Obviously, the EDIRA

¹⁶ In favour of this position, see also Advisory Scientific Committee (2012).

¹⁷ See European Central Bank (2012a, p. 1; 2012b, p. 11).

(European Deposit Insurance and Resolution Authority) would be funded by contributions calculated on the basis of the risks on the balance sheets of the banks that are covered by this insurance. According to one proposal (Schoenmaker and Gros, 2012), these should only be the banks that are subject to stress tests by the EBA. If only partial cover of the European banking system is opted for, then national frameworks will survive and all the problems derived from overlapping jurisdictions and the reluctance to share information will remain (Schoenmaker, 2013).

Finally, if the systems of deposit insurance and those for the resolution of banks in crisis remain national, it is clear that the ultimate guarantor, explicit or implied, is the single member State. Since the Eurozone does not yet have its own budget and that of the European Union, not yet approved by the European Parliament, is limited by an agreement within the Council to 960 billion euros (1% of GDP) for the period 2014-2020, as things stand the guarantee on which a future EDIRA could count on would be rather weak. It has been claimed that it could be provided by the ESM. However, the ESM also has a lending capacity limited to 500 billion euros; its main task is to ensure financial support for the euro area members in trouble, as well as their financial sectors if they constitute a threat to stability and need to be recapitalised. In case of a systemic crisis, can the ESM be sufficient, given that it has already allocated resources to save one or more members from bankruptcy? Maybe not, which confirms the need for a fiscal capacity at the Eurozone level.

6. Risk sharing and stabilization

The reforms that have been proposed, completed or are in process of being approved with regards to oversight, the resolution of troubled banks and deposit insurance, are far from being homogeneous in their setup, and they are rather complex in their articulation. Still, they have yet to achieve the objective repeatedly stated in this period, i.e. breaking the link between banks and public debtors, which significantly reduces contagion, but exacerbates the impact of each financial turbulence. The day on which the ESM will be authorised to recapitalise banks with

insufficient capital because the market is unable to do so, public debt will not inflate, but sovereign bonds will continue to be on banks' balance sheets.

In countries like Italy, Spain and above all Germany, banks have normally been the final holders of national public debt, to a greater extent than their own capital. By contrast, in Britain and France banks have held a lower amount of national public debt relative to their capital. This largely depends on the tradition and financial structure of the country, but also on its regulations:

- a) in terms of risk, the weight given to government bonds being zero, and thus the 'consumption' of capital for banks that invest in it being zero too;
- b) even for the banks that adopt the IRB (Internal Ratings-Based) approach, which would presumably assign a positive (albeit low) level of risk to public bonds, there is the possibility of using the zero weighting provided for in the standard method;
- c) banks invest in short-term government bonds for their own liquidity needs, with repayments chosen as a function of their own deadlines; in case of an earlier need, however, they may easily be sold on the market or pledged to the central bank.

To break the vicious circle between banks and national governments the following has been proposed (Gros, 2013): to recognise the risk of public debt on the basis of objective parameters such as the debt/GDP and deficit/GDP ratios, rather than on the assessments of rating agencies; to abolish the exception accorded to the banks adopting the IRB; to employ other securities, besides sovereign debt, that are just as readily realisable, almost or entirely without losses; to establish a limit to the exposure for each borrower, even for investments in sovereign bonds, to 25% of the bank's capital, thereby forcing banks to diversify their assets and to reduce the home bias. Given the crisis that we are currently experiencing, the call to abolish the rule that assigns a risk-free rating to government bonds is definitely welcome. In terms of liquidity, it is difficult to accept the idea that there are, as a rule, private securities that have greater liquidity than public ones. Thus, if banks have no desire to start managing liquid assets according to their stock market performance,

they must build up reserves in central bank money, which would be very costly for their profit and loss account... Finally, diversification of investments in government bonds, consequent to the introduction of an exposure limit for sovereign debtors as well, can push to increase the overall risk by seeking higher returns, as French and German banks, for example, have experimented with Greek bonds in recent years.

When banks are restricted to lower investments in government securities, when the ESM is able to directly recapitalise banks, and when a proposed EDIRA takes care to guarantee depositors and find a solution for banks in crisis, the Eurozone's banking system, or at least its main players, will almost or entirely untie themselves from the links to the countries in which they are incorporated or in which they mainly operate. Up until now emphasis has been placed, for example by Van Rompuy and the other presidents, on the need to ensure greater democratic legitimacy at the European level and a process to account for the decisions taken. We have to look, however, not only at the area that acquires jurisdiction and power, but also to the State, which loses it and becomes less and less able to respond to citizens' expectations and the challenges of present-day economic stabilization.

Van Rompuy *et al.* have correctly suggested that there should be a fiscal capacity for the Eurozone, but this proposal seems to have been lost on the way. Still, the need for a fiscal branch in a monetary union, which today becomes a banking union, has long been noted by scholars who have explored the implications of the OCAs (optimum currency areas). On this topic I like to remember the contributions of Kenen (1969; 2002), an economist who recently passed away. I can quote, however, also Meade, who wrote before the OCA concept was aired, while the discussion on the merits of EFTA (European Free-Trade Area) versus the EEC (European Economic Community) was intense. Writing on the five approaches to deal with disequilibria in the balance of payments, he said that:

“The integration approach [...] involves – in addition to the formation of a common market for goods and for factors of production and the provision of much greater international liquidity for European monetary authorities – a very extensive range of powers for what would amount to a single

European government. Such a government would have to be able to control central-bank monetary policy and governmental budgetary policy throughout Europe, to determine a single European commercial and exchange rate policy vis-à-vis third countries, and to carry out an effective special-area policy for depressed regions in Europe. [/] This is in my opinion ultimately desirable; let us hope that it will prove ultimately practicable” (Meade, 1957, pp. 387-388).

Many of the conditions mentioned by Meade have been realized over time by the European Economic Community turned into a European Union with the Maastricht Treaty that envisaged the European Central Bank. But a true fiscal arm is still lacking... In truth, the shock that hit Southern Eurozone sovereign debts, with the rise in interest rate spreads to high levels and the simultaneous decrease, up to implying negative yields for virtuous countries, has been highly asymmetric¹⁸ and has stimulated the fantasy of many in devising forms of debt mutualisation, that is an automatic stabiliser for an economy that has become highly financialised with a strong impact on the real economy. The split proposed by some (Delpla and von Weizsäcker, 2010) between “blue bonds,” issued jointly up to say 60% of the debt/GDP ratio of each member State, and “red bonds,” issued by individual countries and with lower seniority, to cover the rest of the public deficit is interesting. An alternative (Moesen and De Grauwe, 2009) is to apply differentiated interest rates to Eurobonds, on the basis of the financial conditions of each member State. The former scheme is prone to the criticism that it ends up encouraging moral hazard if the public finances, and therefore the use of debt, are not kept under strict control by EU institutions or by its partners. The latter seeks to address moral hazard by lowering the average cost of debt while strongly raising the marginal one. Unfortunately, however, the history of public debts teaches us that high marginal rates by the market have usually failed to put public finances in order by limiting or eliminating recourse to debt. Obviously, the two schemes may be combined. The proposal to issue Eurounionbonds (Prodi and Quadrio Curzio, 2011) seems more elaborate, but it also falls prey to

¹⁸ On the excessive austerity imposed on markets through fear and panic see De Grauwe and Ji (2012; 2013).

the criticism that, in order to avoid moral hazard, it is necessary that European public finance be centralised to a considerable extent and/or that State finances be strictly controlled from the top down, with a *requiem* for the national democratic process.

7. The need for a Eurozone budget

In this *excursus* we have seen that the projected EDIRA needs a backstop, namely the EMS. However, this alone may be not sufficient. The need to stabilise sovereign bonds has led many authors to propose various forms of Eurobonds. The banking union itself could stabilise the credit channel, thus isolating the cost of financing for companies and households from that of the State. However, due to the importance and the complexity of the Eurozone, it does not seem feasible that we could rely on only one or a few such mechanisms, unless they are particularly powerful automatic stabilisers, such as an insurance against cyclical unemployment. Concerning the channel of capital movements, in the present crisis it was the cause of the shock, not a factor for its solution. As the market pushes one or more countries into a 'bad' equilibrium, which in turn causes externalities (De Grauwe, 2011), the responsibility for stabilization is up to the institutions, hopefully through predetermined mechanisms, rather than *ad hoc* decisions that are usually delayed by long and contentious negotiations.

Therefore, it seems the time has come to go beyond the Maastricht framework, according to which stabilization was to remain a national responsibility, based on the assumption that each country could count on raising debt in the market in order to offset shocks. Having excluded risk sharing, no system of transfers for the purpose of stabilization was foreseen in the EMU treaties. This is contrary to the basic principles of multi-level finance which, in fact, assign the task of stabilization to central or federal levels (Oates, 1968); the latter becomes even more

essential if limits are placed on the lower levels, as the European Union is doing with respect to member States.¹⁹

If we accept this rationale for the final stage of the EMU, one that I have long supported (Maré and Sarcinelli, 1998; Sarcinelli, 2003) and is also shared by Brussels (European Commission, 2012c), though projected for an unknown tomorrow, then a common budget is needed. This would allow an area like the Eurozone to operate a substantial transfer of resources in the event of adverse shocks affecting one or more regions, in order to combat a recession that concerns the whole area, when monetary policy proves to be less suited or insufficient at providing public goods specific to the area, such as financial and/or economic stability.

Obviously, in the medium term a stabilization function must be neutral from a distribution point of view, that is to say it must not result in net transfers. It may be achieved through:

- a) an insurance against cyclical unemployment, as previously mentioned;
- b) payments and expenditures from the common budget, related to some business cycle index, so as to complement the Stability and Growth Pact, which is based on a balanced budget net of the effects of the cycle;
- c) direct support to reduce the impact of excessive deviations in the interest rate paid by a member state on its sovereign bonds compared with the average (Mario Monti's "anti-spread mechanism");
- d) temporary transfers to member States that vitally depend on the Eurozone's political decisions (as is the case with Greece in recent years).

Obviously, in order to carry out such function, the Eurozone must be able to borrow on the market (Wolff, 2012). The scheme described above was conceived by scholars who are part of the Bruegel group. It does not differ in substance from that proposed by the "Tommaso Padoa-Schioppa Group" from Notre Europe (Enderlein, 2012), except for the fact that

¹⁹ On the relevance of the American experience for the EU see Henning and Kessler (2012).

with the latter the stabilization function is kept separate and distinct from the budget, to keep faith in the expressed principles of not retreating and proposing only the strictly necessary steps towards a political and economic union.²⁰

8. Conclusions

There is no denying that the Eurozone government has been strengthened over the past two years in order to counter market pressures in the form of refinancing difficulties. Those encountered by intermediaries led to deleveraging, while those that hit on the periphery of the Eurozone have caused interest rate spreads to rise and have forced Greece, Ireland, Portugal, Spain and most recently Cyprus to resort to European aid in order to remain solvent. Europe's interventions thus far have been, to say the least, untimely in Greece and messy in Cyprus.

Measures and international treaties have been approved in order not only to strengthen the oversight of public finances but also to extend it to other macroeconomic dimensions. The ESM was established as a permanent body, following the EFSF's (European Financial Stability Facility) three-year lifespan and the EFSM (European Financial Stabilization Mechanism), to allow the financing of a member State in the case of acute difficulties in raising funds in the market. Furthermore, the ECB has enacted three-year refinancing operations that have especially assisted Southern European banks that have been unable to procure funding on the bond or interbank market. These large operations on the part of the ECB, that after a year are beginning to wind down as a result of voluntary repayments, have allowed banks to repay what they owe and to buy sovereign bonds, thus alleviating the financing needs of the treasuries, but did not loosen the close link between bank risk and sovereign risk.

²⁰ For a comprehensive analysis of the approach of the Tommaso Padoa-Schioppa Group, see Sarcinelli (2013a).

Finally, the idea of forming a banking union in a short time is a direct response to the need to return a stabilization capacity to credit markets. Can we hold all this to be sufficient? My negative response is embodied in this long essay. First of all, the banking union requires a fiscal backstop that can be offered only by a sort of Eurozone treasury that can raise its own taxes and has the power to borrow. Moreover, this would only break the link between sovereign risk and bank risk related to last-resort recapitalizations of banks, not the link due to the spread of sovereign bonds in intermediaries' portfolios, unless oversight rules, which currently consider those to be risk-free, are changed. Given the current levels of debt (except in the United States where banks hold a very low share of public debt), not only in Europe but also in Japan, where they represent 18% of total banking assets, the idea of excluding sovereign bonds from banks' portfolios is just not realistic. Their presence constitutes the best insurance against the default risk of public debtors. As I have argued elsewhere (Sarcinelli, 2012b), the presence of sovereign bonds on banks' balance sheets prevented the solution to the sovereign debt crisis from being found in their restructuring, as was implicit in the Maastricht Treaty. The exception is the 'voluntary' haircut administered to the Greek debt, which was painstakingly agreed upon, to be later transformed into the taxation of large deposits in Cyprus. The latter was first highlighted by the President of the Eurogroup as the new model to deal with situations of insolvency just to be later defined, as in the Greek case, as an 'extraordinary and unrepeatable' measure...

All these improvements do not resolve the fundamental coordination problem that afflicts the Eurozone. In the current descending phase of the business cycle, growth is invoked, as rain was in the past, but there is little action at the fiscal level aimed at reviving it, while the focus remains on structural reforms which, if well chosen and implemented, will only have an effect in the medium to long term. Indeed, the agreed preference for fiscal consolidation brings with it the unintended consequence of extending, if not worsening the current recession. If a macroeconomic stabilization mechanism for the entire Eurozone had been available, or at least a semi-automatic one, it would have been possible to have a boost originating from European public finance.

According to the scholars of the Bruegel group (Pisani-Ferry *et al.*, 2013, p. 4),

“a monetary union that is supposed to be stable requires risk-sharing mechanisms. [...] As with normal insurance, such mechanisms are not needed for small incidents but rather for large and unexpected events. [...] As with any form of insurance, strong measures need to be taken to prevent free-riding behaviour. In the case of Europe, this will ultimately require Treaty changes.”

There is no need, in my opinion, for any other reasons to support the necessity of giving the Eurozone a democratically legitimised and administratively empowered fiscal capacity with the aim of stabilization.²¹ The centralization of executive power that is taking place with regards to economic policy is not a temporary phenomenon related to the crisis. Indeed, the latter has exposed the very limits of the Maastricht framework. The balance of powers has shifted in favour of the European Council, increasingly relegating the Commission to the role of implementing common policies. On the one hand, to ensure adequate legitimacy and accountability the national parliaments should be more involved in the commitments that their governments take on in the European Council (de Schoutheete and Micossi, 2013). On the other hand, there should be some form of direct accountability on the part of the Council with regards to the European Parliament. This latter suggestion would be very difficult to achieve. Personally, I think that the first proposal, feasible and democratically impeccable, only serves to exacerbate the conflict of interest to which each member of the Council is subject: they are at the same time the ultimate defender of the national interest and an interpreter, within the body, of the European interest. The two are not necessarily the same, so that the inevitable compromise ends up with the national one prevailing, particularly for the representatives of the larger or more powerful countries. Only a federal solution that separates the governments of the States from that of the Union will be able to resolve the conflict. It is not for tomorrow or the day after

²¹ On the long-term vision of the European Commission see Sarcinelli (2013b).

tomorrow, but it remains in the hearts and minds of those who believe in a future of harmony and peace.

Let me close this discussion by citing a brief passage from Cicero's "Somnium Scipionis" (*De Re Publica*, liber VI, 13): "Nihil est enim illi principi deo, qui omnem mundum regit, quod quidem in terris fiat, acceptius quam concilia coetusque hominum iure sociati." In English it goes: "For nothing on earth is more agreeable to that supreme deity who reigns over the whole universe, than those assemblages and combinations of men united by law." And what aggregation is larger, more productive of law and more committed to peace than the European Union, a Nobel Prize laureate?

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