LUISS Guido Carli
LIBERA UNIVERSITA' INTERNAZIONALE DEGLI STUDI SOCIALI

Dipartimento di Economia e Finanza
Corso Triennale in Economics and Business
Tesi di Laurea Triennale in European Economic History and Policies

THE EMU AND THE BANKING UNION: AN EVALUATION OF THE IMPACTS ON THE EUROPEAN MONETARY INTEGRATION PROCESS

Relatore
Prof. ssa Cecilia Susanna Jona-Lasinio

Candidata
Cecilia Giannini
Matricola 168721

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ABSTRACT

This research provides an analysis of the causes that have led the European authorities to the establishment of the Banking Union within the borders of the European Monetary framework. The Banking Union was conceived to cope with the 2007-financial crisis due to the fact that the EMU was lacking of powerful supranational institutions, whose aim would have been to resolve the crisis in an organized and efficient manner.

It will be made an assessment of the Banking Union's effects on the European monetary integration process and on the economies of EMU Member States, focusing on the willingness of the European leaders to strengthen the European Monetary Union in order to make the participating countries converge and to prevent them from future negative shocks. The purpose of the essay is indeed to investigate the mechanisms that constitute the Banking Union and mostly how they would be relevant in stabilizing the EMU environment damaged by the crisis, as well as their impacts on the welfare of the European countries.

The Banking Union is the first real achievement in the process of European monetary integration since the creation of the Euro and its three pillars will be substantial and significant in addressing the challenges of the crisis. Through its creation the European authorities have set the basis for a stronger and genuine economic monetary union, capable to become more coordinated and competitive than in the past.

INTRODUCTION

The purpose of this essay is to analyse the causes of the establishment of the Banking Union in the European Monetary framework and look at its effects both on the Member countries and on the European monetary integration process.

The creation of the Banking Union falls within the borders of the European Monetary Union (EMU), which was launched with the Maastricht treaty in 1992 with the scope of increasing the European integration across the member states and to make a stronger and sustainable union.

The creation of the common currency was supposed to be the first significant step towards a comprehensive economic union, but in the following years no major advances were made to reach that objective. Up to the financial crisis in 2007, the EMU performed very well, in an environment of economic stability and cooperation between member states. However the outbreak of the crisis, which firstly hit the United States and then it has quickly spread to Europe, brought serious damages to the European Economy and in particular to the Euro Zone. During those years the first doubts were raised about the survival of the Euro and it was shown that the original design of the EMU exhibited significant shortcomings. The financial crisis proved that countries participating in the monetary union were different and diverging in their economic performances, divided between "core" countries, more advanced, and "peripheral" countries, more backward. Further, the Union was lacking of strong centralized institutions able to control and solve the negative shocks in a systematic and effective way. In this regard European authorities agreed on the need of build up a financial, fiscal, economic and political union in order to let the EMU survive and become stronger. It was commonly recognized that it was necessary to move forward in the monetary integration process, in order to make member states converging, to make the Euro Zone stable and to avoid possible future crisis. Accordingly at the end of June 2012, Herman Van Rompuy, president of the European Council, drafted the report "Towards a Genuine Economic and Monetary union", which was conceived as the roadmap to follow to recover from the crisis and to strengthen for the future.

The Banking Union is the first building block to establish and it is followed by a subsequent development of a Fiscal Union, Economic Union and Political Union.

Across the essay it will be demonstrated that the three pillars of the Banking Union, namely the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the European Deposit Guarantee Scheme (EDGS), will be effective in restoring confidence in the European

financial and banking systems, seriously damaged by the crisis. It will be further shown that the creation of the Banking Union in the Euro Zone will favour competitiveness and growth, eliminating the vicious circle, arisen during the crisis, between sovereigns' debt and banks' debt and restoring a coherent monetary policy brought by the ECB across the member countries.

The main issue will be to understand the impacts and the implications of the Banking Union on the European monetary integration process, hence looking closely at its meaning for the member countries' economies. The analysis of the Banking Union will show how much effort is put in place by European Authorities to build up a stronger EMU, removing all doubts on its survival, and to make the countries participating more unified and coordinated.

In this respect, in the first section will be framed the literary review, in which it is going to be made a narrative of the literature relative to the discussions around the themes of the integration monetary process and the crisis, as well as the debates focused on the Banking Union project.

The purpose of the second section, instead, is to analyse the consequences of the financial crisis on the EMU and the main reasons that have brought the European authorities to engage in the Banking Union project.

The third section will focus on the Banking Union framework, as the first building block of the report by Van Rompuy. The three pillars that constitute the union will be investigated in details and it will be evaluated their capability to solve the difficulties resulting from the financial crisis. Hence, in this part will be done an accurate description of the Banking Union architecture and its timeline, looking also at the achievements accomplished by the authorities until the current period.

The fourth and final section will be more forward looking, focused on the benefits that the Banking Union would bring to the EMU, and especially on its meaning and implications for the Euro Zone countries. It will be considered the role of the Union in the European monetary integration process, by making a comparison between the establishment of the Euro and the one of the Banking Union, trying to understand its relevance and importance in the process started twenty years earlier.

SECTION 1

LITERATURE REVIEW

This section provides an overview of several and important papers in order to define a theoretical framework on the issue dealt in the research.

1.1) The origins of the EMU

Barry Eichengreen wrote in 1993 a paper, published on the "*Journal of Economic Literature",* which covers the history of the European Monetary Union from its establishment in 1992. Eichengreen pointed out that "European monetary union is a process for which there exists no historical precedent" since the member countries involved had a long history of monetary and central banks independence and were at that stage trying to be more united under a common currency. But the purpose of the essay is to understand why the European community has embarked on that risky passage.[1] According to the author does not exist empirical evidence proving that the benefits of adopting a common currency exceed the costs, moreover Eichengreen reports that the common currency would erode the monetary autonomy of the states bringing serious welfare losses, in this regard monetary union could not only be justified by the positive effects brought by the reduction in transaction costs. European governments had to balance all benefits and costs and mostly they should have to compare them.

Also Roel Beetsma and Massimo Giuliodori assessed the costs and benefits of the monetary union. They wrote a meaningful paper, published in 2010 on the *Journal of economic Literature,* titled " *The macroeconomic costs and benefits of the EMU and other monetary unions: an overview of recent research". A*s Eichengreen, they also agreed that the understanding of the true benefits and costs of the union is still in progress: "In fact some experts consider the EMU to be a success, some others, instead, (such as Eichengreen) argue that the euro was introduced for political reasons"[2] and the remaining part points out that the creation of a common currency was made after a weighted analysis of the three policy positions of the impossible trinity principle.

[1] Barry Eichengreen (1993), Journal of Economic Literature, Vol. XXXI.
[2] Roel Beetsma and Massimo Giuliodori (2010), Journal of economic Literature Vol. XLVIII.

Since the European countries agreed to have full capital mobility, the best solution would be to move to a fixed exchange rate at the expense of an autonomous monetary policy.[3]

Hence, as well as Eichengreen, the authors believe that a common currency will lead to a loss of monetary autonomy for the member countries, especially in cases in which an autonomous policy reaction is needed to face an economic shock. However, it would be very difficult to assess the real effects of the EMU, mostly when comparing it with the original view of an optimum currency area (OCA), in fact, according to them, the euro-zone is able to spur long-standing structural reforms in order to fulfil the optimum currency area criteria[4]. Moreover the authors have analysed the role of the ECB related to the issue of policy credibility, which is enforced by the principle of quasi-total independence of the European central bank. Lastly they argue that the EMU would be able to avoid the adverse potential spillovers of non-coordinated national monetary policies, such as those arising from competitive devaluations, and they focus their attention on the fiscal side of the story, part that will not be covered.

As well as the Eichengreen's article, another paper has the aim of understanding why the European institutions have decided to take an additional step in the European integration process: "*What is European integration really about? A political guide for economists",* written in the summer 2013 by Enrico Spalaore. This political guide not only scan briefly the history of the European institutions starting from the end of the second world war, but it looks also at the motivations and limitations of the European choice of integrating in a first moment only few areas, in order to reach in a second moment an "ever-closer union". In fact, the real success of the European project was to initially focus on the integration of the parts with lower heterogeneity costs and higher economies of scale such as the trade sector, together with the scope of delegating more power to a supranational institution, having a deeper "institutionalization"[5] and more coordination and cooperation across states. But he concludes that what in the year 2013 is needed, especially to face the financial crisis, is an even closer union which encompasses not only those narrower areas but also broader zones and, mostly, the member states should try to reach a deeper integration forming a banking union, a fiscal union

[3] The impossibility of a simultaneous existence of free capital mobility, monetary independence, and a fixed exchange rate. In fact, in order to have full capital mobility, the European countries should move to a fixed exchange rate.

[4] Robert A. Mundell: "an OCA is formed when the benefit deriving from the elimination of conversion costs are bigger than the costs stemming from the loss of policy autonomy in the case of an adverse shock".

[5] Enrico Spalaore (2013). "What is European integration really about? A political guide for economists." Journal of economic perspectives.

and even a fully political union, essential for the stability of the euro-zone and to maintain a certain degree of cooperation across countries.

Finally a last article might be relevant in this context: "*The real effects of European Monetary Union"* was a paper written in 2006 before the outbreak of the financial crisis, by Philip R. Lane.

Lane argues that it is difficult to assess the long-term effects of the EMU on the economies of the member states, but he tries to analyse in a different manner, with respect to its colleagues, this issue: the consequences of the common currency on the euro-area are drawn by the economic performance of the countries until 2006. On this regard the writer argues that "there have been persistent differences in national inflation rates within the euro area, such that the common monetary policy has not suited all member countries at all times" (Philip R. Lane-2006) and that the euro has amplified some critical divergences between member states. But, at the same time, the EMU has spurred greater cooperation across countries, especially in the cross-border trade in finance and goods. Further, in the article, Lane agrees on the idea that EMU was formed for political reasons, affirming that the creation of a common currency was thought to achieve a further political integration and cooperation, even if in Europe in 2006 there was weak support for a political union since it had not yet been tested how the euro countries would respond to a financial crisis and especially to a banking collapse.[6]

Philip Lane concludes its analysis questioning how the euro-zone institutions, that, during the fists decade of their mandate, until 2006, brought quite positive results to the European economy, would change and evolve in the case of a financial crisis' outbreak.

1.2) Outbreak of the financial crisis

The outbreak of the financial crisis in Europe shocked the stable environment of the euro-zone, which was performing quite steadily until the 2007. In this regard Carlo Panico and Francesco Purificato have analysed, in their paper "*European policy reactions to the financial crisis",* how some significant macroeconomic variables, such as unemployment rate and growth rate, have changed during the transition from the safe environment before 2007 to the turbulent one caused by the failure of the Lehman Brothers in the U.S. Specifically the paper at issue explores

[6] What is going to happen two years later with the financial crisis.

the policy response (only in the year 2008) to the crisis in the euro area, and it makes a distinction between the American reaction and the European one.

The authors look at the measures taken by the monetary authorities both before and after the failure of the investment bank Lehman Brothers and they argue that "during the first period, the effects of the crisis were mainly counter-acted through monetary interventions. During the second, which produced more intense effects, the fiscal authorities have been bound to support the interventions of the monetary ones" (Panico and Purificato.2008). According to them the first phase of reforms has proved to be efficient since the crisis has not brought to the failure of big financial institutions thanks to the punctuality and effectiveness of the monetary policy reactions. But the problem lays in the future uncertainty, which will affect the years after 2008. In fact the writers, based on an ECB's document and unaware of the future dramatic scenario, point out that the next phase would be riskier than the previous one due to a "credit cycle downturn" [7] and it would also need a stronger fiscal response to react to the recession, although, according to Panico and Fortunato, the euro area lacks a strong form of fiscal authority, since it works mainly at national level and would be difficult to implement it effectively and mostly to coordinate it across member states.

Besides them, many other authors in the years following the 2008 wrote about the crisis and the subsequent reforms, giving their suggestions or criticising the actions taken by the European authorities. Two different papers are in fact good examples thereof: "*A reform to respond to the crisis. A European redemption pact*"[8]and "*Five policy options in face of euro crisis*"[9]. Both were published when the negative effects brought by the crisis were clear and, while the first one examines a significant reform taken by the ECB, the second suggests alternative policy reactions to deal with it. In fact the first article's authors refer to the European Redemption pact, drawn by the European leaders to solve in two decades the debt situation of recession countries. The key principle is to disjoint the huge debt accumulated during the crisis by the states into two parts: one consistent with the 60 percent debt threshold imposed by the previous *Growth and Stability pact,* and the remaining exceeding the margin. The main objective of the reform is to aid the member countries to refinance their budget accounts with a joint liability and strong commitment.

[7] Carlo Panico and Francesco Purificato (2008), "European policy reactions to the financial crisis".

[8] Written by Peter Bofinger, Lars P Feld, Wolfgang Franz, Christoph M Schmidt, Beatrice Weder di Mauro and published in November 2011.

[9] Written by Ping yen Lay and Jimmy Teng and published in 2013 on the *Journal of Global Economics.*

In contrast the second article focuses more on the disparities in current account (difference between a nation's savings and its investments) between northern and southern countries. The financial crisis, indeed, brought to a scarcity of investment opportunities and, according to the authors, the euro-zone as a whole would be able to finance all the current account deficits of the countries in trouble. They point out that the problem of the Euro Zone is that there is absence of convergence and coordination across the member countries since the States displaying positive current accounts ("surplus countries"), such as Germany, are not thinking of finance the ones with negative accounts ("deficit countries"). Then, in face of euro crisis, they draw up a list of five alternative solutions, which will be analysed throughout the paper, to restore competitiveness and stabilise the financial sector. The first is internal devaluation combined with bailout, next follow restructuring debt[10], devaluation of euro, default and partial exit of peripheral countries and, as last, complete elimination of euro.

It is the last policy option that will give rise to many discussions, during which economists and writers will question the survival of the euro and specifically of the EMU.

1.3) The euro-zone fragility (and the possible collapse of the Euro) calls for more: A Banking Union

The following three papers advocate for a possible banking union, which would be essential for the survival of euro and to restore confidence in the monetary system.

Andrew Moravcsik, on its article "*How to sustain a common currency",* affirms that the European countries thought that they would successfully converge in their economic performances during the years following the monetary unification. According to the author in fact the aim of the European authorities was to bring together the weaker countries of Southern Europe with the strongest of the Northern part such as Germany. More precisely the latter would accept a more expansionary monetary policy (more government and private spending, higher wages and inflation), while the others, "the deficit-prone" countries, would embrace the German economic standards (low inflation, more savings, less spending). This macroeconomic convergence did not happen during the period prior to the crisis, but Moravcsik recommend that it must be fully reached in the long run, trying to smooth the consequences of the financial crisis, even if, as

[10] As previously mentioned, a reform to restructure the debt would be the *European redemption pact.*

reported by the author, the European countries have tried to some extent to reach a higher degree of cooperation during the recession. In fact, in order to overcome the crises and let the euro survive, the European leaders should try to align the economic performances of each member, such as inflation rates, wages and public spending and the trust in the functioning of the European Union should be restored. In this regard the solutions suggested by Moravcsik would be to narrow the economic gap between Northern and Southern countries and to reinforce the power at supranational level, leaving less space to the national one.

Others two authors have proposed, as a solution to the crisis, to strengthen the supranational power of the EMU. C. Fred Bergsten and Jacob Funk Kirkegaard in their two articles "*The coming resolution of the European Crisis*" and *" The coming resolution of the European crisis: an update*", are in line with Moravcsik's thought, in that, the lack of confidence in the euro, stemmed from the recession, is a consequence of an incomplete architecture put forward by the European leaders in 1992. They indeed point out that, at the time of EMU formation, a full economic union (comprehensive of banking and fiscal union) did not follow it, even though the fathers of the European integration expected that a comprehensive economic union would have supervene directly from the establishment of the monetary union. This erroneous design was made clear by the financial crisis, which calls for more cooperation and convergence of the members. In this regard the authors refer to the fact that the EMU was lacking of strong, centralized institutions, capable of restoring and ensuring the economic stability of the euro-area. They thus suggest that governments should concede part of their national power in favor of supranational institutions, which would be able to construct in the long term both a banking and a fiscal union helped by a stronger cooperation of the States.

Are exactly the banking union and the fiscal union the core themes of the discussion brought by Kevin H. O'Rourke and Alan M. Taylor in their paper "*Cross of Euros"* published in 2013. As well as the previous authors, they start their analysis talking about the catastrophic consequences of the financial crisis and the subsequent lost of confident by the euro-zone citizens' in European institutions and especially in the Euro.[11] O'Rourke and Taylor pass trough some historical analogies such as Gold standard and American monetary system to address three main questions: the first refers to which macroeconomic policy mix in the short run would be consistent with the policies of the 17 member countries; the second instead focuses on which

[11] The authors have stated in fact that reported "distrust" in the European Union exceeds "trust" in 15 out of 17 countries.

level of institutional framework the euro zone should build up for the survival of the euro in the medium term; the last relates to how the costs of a euro zone dissolution could be minimized.
The historical examples have helped the two authors to conclude that the Euro Zone policy makers should implement an extended institutional framework, by establishing an European Banking Union, which would consist of three distinct mechanisms: a centralized banking supervision, a common resolution mechanism and a common deposit insurance scheme. In this regard O'Rourke and Taylor affirm that: "where the euro-zone needs to go in the long run, is towards a genuine banking union", which could be successfully completed only if banks would be left to default, without affecting the treasury of the governments and if financial institutions would begin to restructure their debt without damaging the whole banking system of the Euro Zone, which is highly interconnected.

1.4) Banking union

This section provides the opinions of three scholars on the new agreement, set up by the European commission together with the European authorities, to form a European Banking Union. This accord will be one of the four building blocks towards a "genuine Economic and Monetary Union"[12] to restore confidence in banks and Euro and its landmark will be the establishment of the Single Supervisory Mechanism (SSM).
Accordingly, Angel Ubide in October 2013 wrote the article "*How to form a more Perfect European banking union".* Ubide investigates on the causes which could have brought the European politicians to engage in such agreement in the difficult moment of the financial crisis, and, what he believes, is that the idea of forming a banking union derives from the fact that it is the easiest alternative to implement among many others and not because he was seen by the leaders as the best one to undertake. In fact he points out that, even though the creation of a banking union would restore to some extent the confidence in the Euro Zone banking system, on the other end it could give rise, due to its ambiguity, to some unexpected negative consequences, in that it is designated inefficiently due to the minimal euro area backstop for a very last resort and the national bail-ins of the creditor (actions, according to Ubide, more

[12] The report "*Towards a genuine Economic and Monetary Union"* by the President of the European Council Herman Van Rompuy, advises the establishment of a banking union and sets out a vision for the future of Economic and Monetary Union and how it can best contribute to growth, jobs and stability.

concentrated on the past instead of being forward looking). In fact the author questions if the current banking system scheme is the best one to enhance growth and to move towards a closer union and if it would be able to soften the national borders, principal prerogative to attain a stable European environment.

As Angel Ubide, also Iain Begg has some doubts on the current design of the banking union. Indeed, in 2012 he published an article called "*Banking union: inevitably, but profoundly challenging?".* Iain Begg agrees with Ubide in the fact that in the long run strong policies for the European banking sector are needed and that they should be stated and implemented with a clear design. In fact the author argues that is not clearly understandable which are the goals of the agreement, what it will entail and what it will be able to solve. Its suggestions, though, are to make sure that the European leaders make clear each steps necessary to reach a genuine banking union, as well as its final goal, rather than give importance only on the short term ones.

Instead, does not have the same opinion Nicolas Vèron, the last author to be analysed in this literary review. At Bruegel[13] he published at the end of 2012 "*Europe's single supervisory mechanism and the long journey towards banking union".* Differently from Begg and Ubide, Vèron does not mention the ambiguity as characteristic of the process towards the banking union; he instead begins its paper by stating that the foundation of a banking union is necessary to make the Euro survive, because the banking sector has been the most damaged, being at the heart of the financial crisis[14]. Further another justification for its establishment would be that the investments are, to a large extent, financed by banks, and not by financial markets. He in fact describes the needed steps that the European commission is undertaking to move forward in the project, such as the establishment of the Single Supervisory Mechanism (SSM), reforms of the EBA (European banking authority) and giving to the ECB full supervisory powers; but the author argues that the huge involvement of the ECB in this project calls for more elaboration and additional adjustments. Further, through out its discussion, Vèron defines the future role of the banking system, its objectives and the institutions involved in the project, stating that the full accomplishment of this design will be a "long journey", characterized by a high degree of complexity. Another important issue that the author highlights is the involvement of the other

[13] Bruegel is a European think tank specialized in economics.

[14] Nicolas Vèron states: "The 'doom loop' linking sovereign and banking credit conditions has been correctly identified as a key transmission channel that needs to be addressed to prevent further deterioration and so that eventual improvements can be envisaged".

EU states, which are not part of the euro-area. Since, according to the article 127(6)[15], the ECB would be entitled of supervising the SSM, also non-euro countries should be involved in the banking union with rights and duties, obviously the ones which desire to participate. The author concludes with an appeal directed to the European leaders of moving in time and promptly because a lack of a rapid action would lead to further doubts and pessimism on the effective capacity of decision-making of the European authorities and consequently on the possible survival of euro. Hence it is necessary to rebuild the optimism in the Euro Zone countries in order to feed the expectations, of both authorities and citizens, about the future. The enthusiasm to go ahead in the process should be restored with the scope to sustain with energy and assurance each activity that will be undertaken by authorities.

[15] Art. 127(6):"The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions".

SECTION 2

GENESIS

The Eurozone has spent its first ten years of existence in an environment characterized by economic stability and growth, however the year 2007 broke the delicate equilibrium that up to that time had made the Euro area stable and cohesive. Eurozone member states, indeed, were affected by the financial crisis that broke out in US during the summer of 2007 when the economy of the United States began to collapse. The spark came from the real-estate sector, in that the American banks were keeping financing with loans all the people interested in buying a house without ensuring that they were able to pay it back. Hence mortgage loans were given also too highly risky borrowers, which now could afford to buy extremely expensive houses, whose prices continued to rise, thus going to create a worrying housing bubble. When the houses' prices began to decline the low-income borrowers stopped to repay the mortgage loans, hence all the banks holding the subprime mortgages started to face huge losses. Since the US banking sector was closely tied and interconnected with the ones of UK, Germany and France, the financial crisis spread rapidly to Europe causing a loss in trust between banks, which were not more keen to lend money both to investors and to others financial institutions causing a sharp decline in the availability of money and credit and thus creating a credit crunch between banks.

The first action to avoid a credit freeze was brought by the European Central Bank (ECB), which already on the 9th of August 2007 injected €95bn into the European interbank market in order to restore confidence and to decrease the lending rate, however this liquidity action was not sufficient to avoid the collapse of several overleveraged banks: in September 2007 the Northern Rock in UK was exposed to a bank-run and thus, to avoid its failure, it was nationalized by the British government. Subsequently, after the failure of some of the largest investment banks in US (Lehman Brothers, Bear Stearns and Merrill Lynch), the governments of Belgium, Netherland, Luxemburg and France were obliged to bail out Fortis and Dexia, while the German one rescued the holding Hypo Real Estate[16]. Since all these institutions were connected to the American banking system through collateralized debt obligations (CDOs)[17], the Euro Zone governments

[16] "How to fix the Euro. Strengthening Economic Governance in Europe". Chatham House, Elcano and Arel (March 2014)

[17] One of the main reasons why the US subprime mortgage crisis spread so quickly to Europe is in fact linked to the broad adoption of the so-called originate-to-distribute model, under which the US banks

were convinced that the financial instability was mostly an "Anglo-Saxon problem" (Cit. Chatman House, Elcano and Arel-2014), thus, in contrast to US and UK which carried out substantial actions, the rest of the Euro Area responded with uncoordinated and weak measures. Although, after few months, policy-makers became aware that the financial crisis was not merely American and therefore that the whole European financial system was in danger, needing strong policy measures.

In October 2008 the ECB adapted its actions to respond to the crisis. In a first moment through huge liquidity injections and, in a second moment, it made use of others programs such as the Outright Monetary Transaction (OMT) and the Long Term Refinancing Operations (LTROs).

Concerning the Outright Monetary Transaction measure, the ECB could, if requested, buy government bonds with maturity up to three years.

With regards to the LTROs the ECB finances all the Euro Zone banks, which suffer from lack of liquidity in order to stimulate their lending acts.

The ECB, hence, took charge in solving the financial instability and its president Mario Draghi cut the interest rates to control prices, indeed he gave a declaration speech in which he affirmed that the ECB would do whatever needed to stabilize the Euro Zone. The primary objective of the European Central Bank, in fact, is to maintain price stability within the Euro Zone. As a matter of fact price stability is pursued when the inflation rate is around 2 per cent, and this threshold has to be maintained also in the medium term. Further, the ECB's president is in charge of conducting a coherent monetary policy across the eighteen countries belonging to the Euro Zone and this is due thanks to its high degree of independency. The ECB's independence is in fact stated in the Treaty and therefore European governments and the others EU institutions cannot influence its actions aimed at pursuing price stability. However the European Central bank is not totally detached from member states, because it is part of the Eurosystem, which includes both the ECB and the national central banks and whose mission follows the one of the Central Bank: " We in the Eurosystem have as our primary objective the maintenance of price stability for the common good. Acting also as a leading financial authority, we aim to safeguard financial stability and promote European financial integration. In pursuing our objectives, we attach utmost importance to credibility, trust, transparency and accountability" (European Central Bank-Eurosystem).

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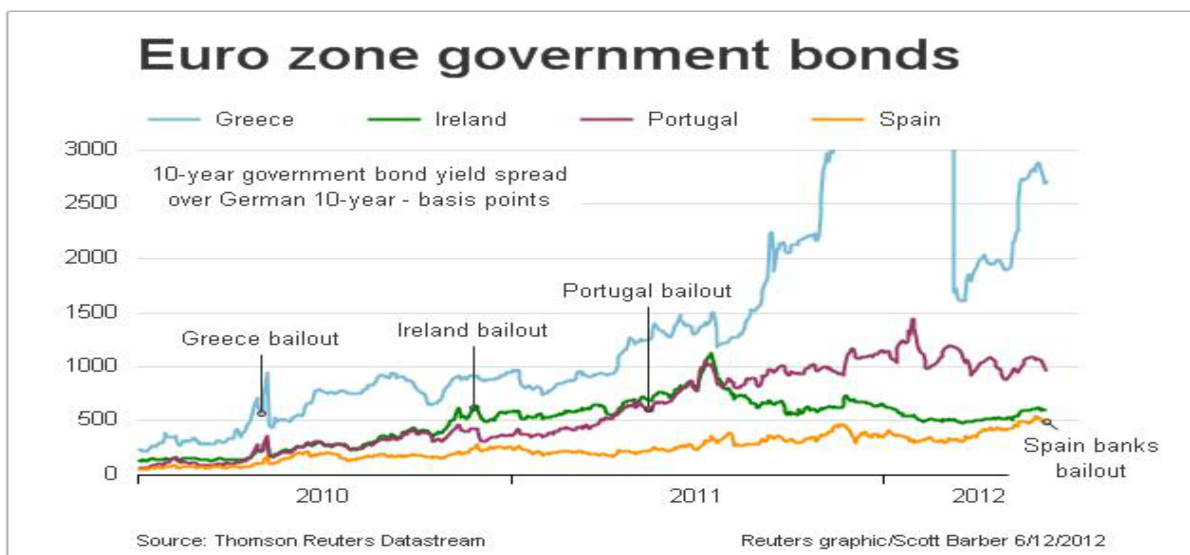
used to bundle their own (subprime) claims and pass them to a special-purpose vehicle, which then sell the resulting securities to the EU financial market.

Even if, during its first ten years of existence, the ECB had been able to control prices and to maintain a coherent monetary policy, when the financial crisis at the beginning of 2009 began to seriously damage the governments of the Member States[18], several imbalances and weaknesses appeared. During those months the Euro Zone GDP dropped by 4.3 per cent, trade was hardly hit and there was a huge increase, above the allowed 60 per cent, in the debt-to-GDP ratios among the European countries. To some extent the public debt was due to the falling growth, but the main reason was that governments bailed out many banks, thus increasing their budget deficits. At the same time, banks began to fill their balance sheets with Governments bonds, but the instability brought by the crisis led the banking system to have serious doubts on the safety of the bonds issued by the public sector. A vicious circle thus arose between banks and governments: banks were used to hold government bonds because considered as safe assets, but in the case in which the public sector was no more able to pay back its debt obligations, banks would be exposed to large losses and eventually could risk the collapse. Consequently governments should be called to bail out the bank in question. This was the situation that several European governments and banks were facing since 2009: on one side the huge banks losses, on the other side the deep budget deficits. Italy for example fell in this loop because of its high pre-existing debt, Spain and Portugal as a result of a drop in government revenues caused by the low growth, while Ireland was exposed to the vicious circle because its government was obliged to bail out two large banks.

The governments of those countries were no more perceived as safe in that they were at risk of not being able to repay the huge debt that had been created, therefore their government interest rate started to diverge from the one of the German Bund, considered instead the safest one, while, on the contrast, before the crisis, the difference between the German interest rates and the ones of Ireland, Spain, Italy and Portugal was close to zero. The birth of the spreads and their sharp increase showed clearly that each member state was acting independently to face the crisis, governments were in fact pursuing different actions, purely at national level, proving that fiscal policies in the Euro Zone countries were different and diverging.

[18] As a matter of fact, in 2009, from a purely financial crisis, it turned to be the so-called "sovereign-debt" crisis.

FIGURE 1: Euro Zone government bonds (Thomson Reuters Datastream)



[19]

As figure 1 shows, interest rate spreads differ from country to country. Further the more financial markets worry about the public finances' safety, the higher the interest rates will be demanded for borrowing, this is why the spreads are a good measure of a country's financial position.

Even though the spreads were continuing to rise, governments did not realize their possible negative effects until Greece had to be rescued in May 2010. The Greek government account, before the end of 2009, was under control even though the debt-to-GDP ratio was 105 per cent, but in the moment in which George Papandreu was elected the situation changed dramatically: the government debt rose to 127 per cent (as percentage of GDP) broadening even more the budget deficits[20]. As a consequence markets began to fear that the Greek government would become soon insolvent, causing a drastic increase of the spreads (from quasi-parity to double number) and thus heightening the borrowing cost for Greece.

The interest rate volatility started to increase, with the wholesale and corporate funds shifting from weak counties to the ones perceived as stable. As a result, the crisis starts to put the common currency under pressure. Since monetary aggregates are composed to a large extent by the liabilities created by the banking sector, investors began to perceive the same euro deposited in a weak country as Greece not carrying the same value as a euro deposited in a German bank[21].

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[19] Graph's source: Thomson Reuters Datastream

[20] Richard Baldwin and Charles Wyplosz (2012), "The economics of European integration".

[21] Benoît Coeuré (2013), "Adjustment and growth in the euro area economies" Nova School of Business and Economics and the Bank of Portugal, Lisbon.

During the following months the financial situation worsen and the Greek government began to negotiate with the International Monetary Fund (IMF) an emergency loan, which was finally allowed in May 2010 for an amount of €110 billion. In the meantime the crisis in the Euro Zone deepened, the interest rates across countries continued to diverge and the Euro depreciated. The governments as consequence decided to establish a new institution, the European Financial Stability Facility (EFSF), in charge of financing countries in trouble, a €500 billion rescue Fund[22].

One might wonder why the crisis has spread so dramatically in the Euro Zone and why the member countries, which should be coordinated and integrated since 1992, were diverging that much. One possible explanation could bring back to the 1992 when the Maastricht Treaty was signed. When the fathers of European integration in 1990 drawn up the *one market one Money* report, they measured the advantages and disadvantages of the European Monetary Union, including the idea that that the common currency should have been only the first step towards a closer union, comprising also common fiscal and political policies. The creation of the common currency, in fact, was thought to achieve a higher degree of cooperation and the member countries' primary objective was to achieve a full integration before any possible crisis outbreak in order to react similarly at the negative shocks. What happened in the reality was exactly the opposite situation: the countries showed different budget account deficits, different price levels and therefore different inflation rates; further some governments pursued an expansionary fiscal policy and some others a contractionary one, leading thus to the division between surplus countries such as Germany and deficit countries such as Italy or Spain.

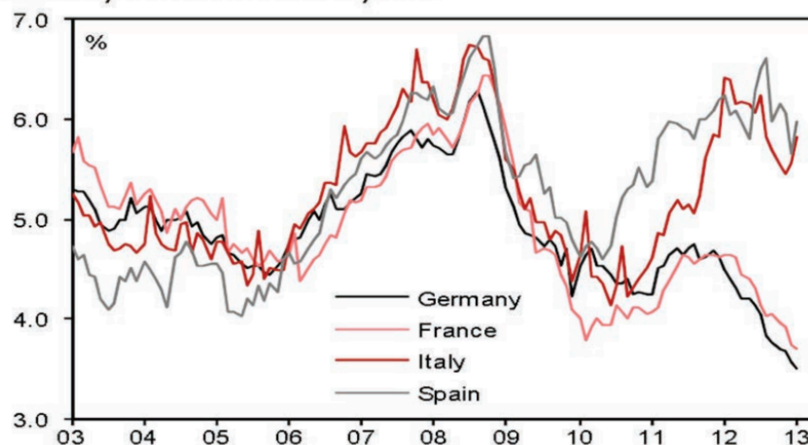
Another possible explanation is the highly interconnected banking system, which suffered, to a large extent, the financial, but essentially the sovereign-debt crisis. In this regard the Bank for International Settlements assessed that the German and French banking systems were profoundly connected to the ones of the countries more in recession (Greece, Spain, Portugal and Ireland). Before 2007 in fact the Euro Zone banking system was extremely integrated and thus could be viewed as a single big market, but it was lacking of a strong protection system at supranational level[23]. During the first years of the crisis, indeed, the banks were guaranteed only at national level and mostly backed up by the government. This is the reason why the external

[22] Even though the EFSF resources were made available to recapitalise banks, the EFSF was not able to break the vicious circle between bank and sovereign state because the financing should have been directed to Member States, which would have maintained therefore the responsibility for supporting banks.

[23] Andrea Enria (2013), "The crisis in Europe, the impact on banks and the authorities' response, Università degli Studi di Trento.

investors, in deciding in which bank would be more suitable to invest, checked and looked at the credit rating (i.e. ability to repay loans) of the bank's country origin and at the amount of sovereign bonds present in the bank's balance sheet. In other words, if the country protecting the bank suffered of financial instability and of a huge debt, the interest rate on loans charged by the domestic bank would increase, leading to a divergence of interest rates across member states. This event changed the nature of the European banking system, from a highly integrated system to a more fragmented one. The causes of this "balkanization" (from Andrea Enria, 2013) must be found in the roots of the crisis: the financial instability and lack of trust in the interbank market caused a credit freeze in that banks did not want to rely anymore on the others' bank loans, but rather chose to depend only on the domestic market.

FUGURE 2:



Source: EBA

As figure 2 shows, one of the main consequences of the banking system fragmentation was the difference in lending rates towards small and medium enterprises around the EMU countries. In fact, since 2011, the average interest rates on loans between "core" countries and "peripheral" countries have been extremely diverging causing several different schemes of financing across the Euro Zone[24]. All this had an impact on the role and powers of the ECB, in that it was no longer able to pursue a coherent a coordinated monetary policy across the member states, failing its duty to ensure price stability.

The balkanization of the banking system violated the impossible trinity principle based on the Mundell-Fleming model. The monetary trilemma assumes that a fixed exchange rate, full capital

[24] Andrea Enria (2013), "L'unione bancaria europea vista da Londra". European Banking Authority.

mobility and national monetary policy cannot coexist at the same time, thus only two of these three policy options can be pursued simultaneously. On the contrary, during the crisis, the three principles were operating concurrently: the exchange rate was fixed, as a consequence the national governments could not independently evaluate or depreciate the currency to respond to an adverse shock, the Euro Zone market were characterized by full capital mobility and each government was pursuing its own autonomous monetary policy, even though, at the time of the unification, Euro Area countries agreed to transfer the monetary instrument to the European Central Bank.

On the financial side, instead, Schoenmaker proposed a similar model, which demonstrates, as well, the breach of the impossible trinity: there were financial stability pursued by the ECB and related institutions, financial integration between markets and banks and the financial policies carried on at national level.[25]

During the years 2010 and 2011 the environment in the Euro Zone was thus unstable, member countries were increasingly diverging and the banking system was disunite and freezed, as a consequence national authorities were not relying on a supranational institution to face the unfolding crisis. The firsts doubts on Euro Zone survival were raised and policy-makers and governments began to think that the original EMU design should have been adjusted. They questioned then that the architecture put forward by the European leaders in 1992 was incomplete or even wrong, since an economic union, comprehensive of banking and fiscal union, did not follow after the EMU creation. On the contrary the financial crisis has shown how far from each other were the countries from an economic perspective, further it has clearly proved that the monetary system lacked of strong supranational institutions able to alleviate the huge divergences, since the cooperation between surplus and deficit countries had essentially disappeared.[26] The Euro Zone authorities thus recognized that they should have to implement e a new project, aimed at coordinating the economic policies in order to ensure a stronger cooperation among the Member States. The European leaders should trust in the democratic nature of the union and give up part of their nation power in favor of stronger centralized institutions (Andrew Moravcsik, 2012).

[25] Dirk Shoenmaker (2011), "The financial trilemma".

[26] Andrew Moravcsik (2012), "Europe after crisis-how to sustain a common currency".

The above-mentioned project was draft and discussed in Brussels at the end of June 2012. The president of the European Council Herman Van Rompuy, in collaboration with the Presidents of the Commission, the European Central Bank and the Eurogroup, prepared a report, titled "*Towards a genuine economic and monetary union"*, which displayed a roadmap to strengthen the economic performance of the EMU. Herman Van Rompuy in fact affirmed that "the economic and monetary union (EMU) was established to bring prosperity and stability across Europe and that the EMU is now facing a fundamental challenge. It needs to be strengthen". Therefore the four presidents suggested to build, over the next ten years, a stable frame to the EMU architecture, which should comprise four building blocks, which would be essential for the EMU genuine growth.

The first pillar refers to *an integrated financial framework.* European leaders agreed on forming a Banking Union to ensure financial stability, to shift bank supervision from a national level to a supranational one, to reduce bank failures' costs, to have a common resolution mechanism for bank crisis and finally to guarantee with a same scheme and procedures the European depositors.

The second element of the report is to build *an integrated budgetary framework*: a step towards a fiscal union to strengthen the governments' accounts and their budgets, since the Euro Zone needs common programs to correct and supervise the fiscal policies of the countries. This building block contains also the process towards common debt issuance.

The third pillar relates to *an integrated economic policy framework*, that is an economic union to ensure that national policies are aligned with the idea of a sustainable economic growth and at the same time favoring employment and competitiveness. The European leaders would do whatever needed to encourage convergence of policies among the member countries and resolve imbalances in order to create a common response to adverse shocks. This pillar is compatible and it is a necessary consequence of the fiscal and banking union.

Lastly, would be necessary to ensure the required *democratic legitimacy and accountability* of decision-making within the EMU. Any joint decision taken at the centralized level should be accountable and legitimate (political union).[27]

[27] Herman Van Rompuy (2012), "Towards a genuine economic and monetary union".

SECTION 3

THE BANKING UNION

The reasons for which the establishment of the Banking Union is one of the four building blocks are many and all equally important. Above all it should be considered that the Euro Zone banking system finances the 75 per cent of the real economy demand,[28] thus it would be essential to form an integrated and unified systems of banks in order to reinforce the financial dimension of the Euro Zone. European policy-makers, during the drafting of the report, perceived that it was necessary to adjust the architecture and the structure of the banking field with the scope of restoring trust and sound to its functioning.

Moreover the need of building a Banking Union derived from the perception that the current design of the EMU was no longer suitable to solve the crisis. In fact all the monetary actions taken by the ECB up to that point were not conclusive nor decisive: firstly because the ECB could no more transmit the monetary policies coherently across the member states, secondly because the choice to reduce the interest rates to unprecedented levels failed to re-boost completely the circulation of credit. The lack and the subsequent need of a banking union were made explicit by the financial crisis, which, as stated before, fragmented the banking sector, leading to the birth of doubts about "the singleness of the Euro". Further a banking union could be the only relevant solution to the strong tie between banks and related states.

The vicious circle matured during the crisis, indeed, was another consequence of the weak design of the EMU, in that the performance of the states was too linked to the ones of its banks. As a matter of fact, in many occasions governments were obliged to bail out banks, thus burdening even more their budgets and increasing their debts, consequently both the banks and the States were perceived from the markets and investors unstable and unreliable, making the borrowing interest rates higher and giving rise to the birth of the interest rates spread.

According to the Chairman of the BIS Christian Noyer[29], indeed, the dangerous loop between banks and states was a consequence of the lack of a common and coordinated banking system. Since, before the crisis, the banking system was highly integrated and the Euro Zone was characterized by full capital mobility, it was clear that whenever a bank in a country defaults, a

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[28] Vitor Constancio (2014), "Reflections on financial integration and stability".

[29] Noyer (2014), "Why the Economic and Monetary Union needs a banking Union".

banking crisis contagion would easily spread all around the Euro Area. Instead, the existence of the banking union, which ensures strong supervision and control, would have avoided the possibility that a country in difficulty could destroy the financial equilibrium of the Euro Area.

Banking union is the first step to ensure growth and competitiveness across the Euro Zone and it could be one of the best policy measure able to avoid the vicious circle, because the foundation of the single resolution mechanism (SRM) would eliminate the risk that the states would be seen obliged to bail out the banks and consequently there would be the possibility to have a single institution for Euro Area banks' crisis.

Moreover the introduction of a cumulative scheme of supervision would prevent the European banks to charge different interest rates to the companies and would merge all the schemes for deposits and credits that up to that point were differing from country to country. In fact, its introduction would strengthen the power of the supranational institutions giving to the Union a more federalist and democratic approach. The banks will thus no longer be supervised at national level, but rather they will be under the control of a centralized and independent authority.[30]

3.1) THE ROLE OF THE BANKING UNION IN THE EUROPEAN INTEGRATION PROCESS

Since the creation of the single currency no more progresses were done towards a more advanced integration. Even though the creation of Euro was the first big step in the European history, it was not conceived to be left alone and even the European Central Bank was supposed to be the precursor of others institutions in the fiscal and banking sector and not remaining one of the few monetary supranational European institutions. In this regard, many of the founding fathers of the Monetary Union expected the Euro to be an ambassador and primogenitor of a comprehensive economic union, not the end of the European integration history. Only the crisis, although negative, gave the impetus to proceed further in the process and the banking union is considered by many to be the first real European reform since the common currency. The single currency and the single market allowed Euro Zone to became financially highly interconnected, and the ECB was able, in its first decade in office, to pursue financial stability, thus it was not possible that at the same time European governments were seeking at their own national

[30] Avaro and Sterdyniak (2013), "Banking Union: a solution to the euro zone crisis?".

interests, threatening to break the financial equilibrium in case of a crisis.[31] Since a well-integrated Euro Zone requires the countries to converge in their financial and economic performances, the Banking Union would be able to eliminate some of the disparities that had form before and during the 2008-crisis. It indeed “should contribute to the creation of truly pan-European banks and enhance cross-border banking integration” (Cit. Vitor Constancio, 2014).

It could also pave the way for Fiscal, Economic and Political Unions. All four would allow the Monetary Union to become “United States of Europe”, following the path of the United States of America. The last building block, to form a Political Union, would be essential for this objective and will give the democratic legitimacy to the others three.

The four pillars would improve in the long run the welfare of the European citizens, which will be requested to take part in the Euro Zone affairs and to become “European citizens” not, “Italian”, “Spanish” or “French”, as well as for the States, which would pursue the European interests, not their owns.

3.2) THE THREE PILLARS

The Banking Union is composed by three building blocks: a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) and a European deposit guarantee scheme (EDGS).

Regarding the first pillar, the SSM, European policy-makers agreed on a common institution at EU level, which will supervise all banks. It would allow a uniform supervisory scheme for all the Euro Zone countries in order to better control the banks’ activities. The SSM will prescribe homogeneous methods to enhance and sustain banks’ internal model, hence the rules and standards that banks have to follow will converge.

Cooperative supervisory teams, composed by members of the ECB and the Single Supervisory Mechanism (SSM) together with National Competent authorities, will be responsible of supervising the conduct of the banks in order to lower the fragmentation and reduce the financial barriers across States.[32]

Concerning the SRM, a centralized institution will be in in charge for the resolution of banks’ crisis in the Euro Zone. This would break the vicious circle between banks and sovereign States, in that the latter will no longer, at least as a last resort, take the burden of rescue banks or recapitalize them. There will be put in place, in fact, a systematic resolution of banks, with a

[31] Schoenmaker (2011), Financial trilemma.

[32] Constancio (2014), “ Banking Union and European integration”.

specific and clear method in order to avoid any biased decision taken by the member states, which otherwise would pursue their own interests, without taking into account the possible consequences on the whole area.

The SRM will be complemented with a Single Resolution Fund, financed through banks' loans, which will be characterized by a common fund for all the countries participating. This pillar is a fundamental counterpart of the SSM because it would be ambiguous to carry on the supervisory power at supranational level and the resolution one at national level.

Turning to the last Banking Union's building block, a European deposit guarantee scheme, it would secure the savers' deposit up to a certain limit in case of bank default. This would, on one hand, prevent the banks to be exposed to bank runs by savers due to a lack of trust in the reliability of the banking system, on the other hand it would guarantee part of their savings.[33]

3.3) THE SINGLE SUPERVISORY MECHANISM-SSM

In the fourth year of the crisis, the European leaders agreed on establish a unique supervisory scheme for the Euro Zone banks: the Single Supervisory Mechanism. In other words the supervisory power would shift from national governments to a supranational institution. The latter would be characterized by a high degree of independence, in that this particular power would now be pursued without any interference from governments and their political parties, therefore the choices would no longer be subject to the specific nature of the country and thus biased, but rather they would be clear and unambiguous.

Going back to the financial trilemma by Dirk Shoenmaker, this mechanism would fix the problem that all three principles are operating at the same time. By elevating the supervisory power at a higher level, financial integration and financial stability can now be achieved stably without the interference of many different national policies.

The SSM is based on four key assumptions: firstly it will avoid delays in the resolution of banks' crisis due to the fact that it will monitor the activity of the financial institutions in order to prevent their failure and consequently quasi-irretrievable situations. The banks in trouble in fact will be immediately submitted to control and examined by the central authority.

Secondly the supervisory authority must be highly reliable. Member States should trust in its independent nature, but especially they should believe in its role of supervising financial

[33] European Commission: The EU single Market

institutions because the financing activities of the Banking system depends strongly on the level of safety of the sector.

Thirdly the SSM would be able to avoid the moral hazard, which during the crisis had an influence on the performance of the banks. The latter in fact, based on the confidence that the governments would rescue them, engaged in extremely risky activities, not in compliance with the capital requirements and with the levels of debt allowed. This mechanism instead is based on the principle that banks in trouble will not be saved anymore and this would lead them to be more moderate and cautious in choosing investments.[34]

Lastly the SSM will verify the fulfillment of the Basel III standards: starting from 2014 the European banks are required to reconstruct their balance-sheets and their levels of debt and capital, by increasing the Core Tier 1 ratio (the best form of capital) from 2 to 4.5% of banks' assets and the TIER 1 from 4 per cent to 6 per cent (Maylis Avaro and Henri Sterdyniak, 2013).

To let the SSM operate, the ECB is implementing a comprehensive assessment to understand and check the financial situation of the European banks. It includes three steps: a *risk assessment* of the banks' balance sheets in order to diagnose the risky assets present in it. An *Asset quality review (*AQR) to assess the quality and the clarity of the banks' assets and its capital and at last a *stress test* to evaluate the recovery ability of the banks in case of a banking crisis. The comprehensive assessment is carried out by independent analysts and external auditors, which will base their evaluations on the transparency principle. The SSM will enter into force in November 2014 and the results of the assessment will be published in advance with the hope that banks have in part recovered their damaged balance sheet.[35]

The question now is which institution is going to supervise the banks. The debate turns around two mail dilemmas: will the European leaders establish a new institution or will they exploit the already established one? And, if countries decide to rely on an old institution, which would be more suitable between the ECB and the EBA?

Regarding the first dilemma, the Vice-president of the ECB has stated that the Euro Zone could rely on already existing institutions and he added that the ECB was ready to pursue the supervisory activity. The doubts on which authority between ECB and EBA have been solved after a careful analysis of their tasks and past performance. The EBA, in charge of guarantee financial stability through a prudential supervision since 2010, has experienced during the crisis a drop in

[34] Maylis Avaro and Hneri Sterdniak (2013), *"*Banking union: a solution to the Euro Zone crisis?".
[35] Vitor Constancio (2013), "Banking Union and the European crisis*".*

credibility because of an imprecise result of a stress test it implemented in 2011. Further its head quarter is located in London, city of a country that will not take part to the Banking Union.

At the end, European authorities, following Art. 127.6 of the treaty on Functioning of the European Union[36], opted for the ECB thanks to its experience in the field and its expertise in banking issues. It is also one of the most independent banks around the world and this has also influenced the choice. The ECB will be entitled of develop the standards that banks should follow such as the application of the Single Rulebook[37] and it will be liable of monitoring all the activities of banks under its control, including the analysis of the their debts, capitals and liquidity levels.

For what concerns the supervision activity *Joint supervisory teams (*JST) will be formed, composed by ECB staff and *National Competent Authorities* (NCAs) in order to pursue control over banks both at national and supranational levels. NCAs will be in charge of supervising smaller banks and thus less significant for the inter-bank market, but still these financial institutions will be part of the SSM; on the contrary the ECB will supervise the most significant and large banks, whose number is approximately 120 (Vitor Constancio, 2013). This dual authority makes possible to have at the same time centralized and decentralized powers in order to better cope with a heterogeneous banking sector.

The increase in cross-border activities among banks is one of the main advantages stemming from the SSM because fragmentation of the banking sector would be reduced and a healthy competition would be restored. As a consequence the credit flow between banks and investors would be revitalized, by boosting investments and growth, hence trust in the banking system would be rebuilt.

The cross-border integration could lead to another positive result: risk sharing. Since the Euro Zone is not backed up by a significant common budget, in the case of an asymmetric shock, banks could support each other through emergency loans (for example “When a country’s residents hold claims to dividends, interest or rental income from investments in other countries” (Vitor Constancio, 2014).

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[36] Art 127.6: “The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings”.

[37] The Rulebook is prepared by the EBA and implements a common legal framework for supervision.

3.4) THE SINGLE RESOLUTION MECHANISM-SRM

As for the SSM, the second building block of the Banking Union relies on a common centralized institution in charge of the resolution and recovery of banks distressed. Until June 2012 "*Towards a genuine economic and monetary union"* report) banks' crisis resolution was carried at national level according to the country-specific regulation, the SRM instead had shifted the resolution power at European level.

The SRM is based on three aspects:

1. It will prevent ahead banks from failure, in that banks will be asked beforehand to build recovery plans needed when crisis occur.
2. European banking authorities will be instructed on the procedures and rules to follow in the resolution process and will be given to them the possibility to fire managers of the bank in difficulty.
3. National governments will be in charge, under the control of the European resolution authority, of exploit all the tools provided by the central body to recapitalize the financial institution.

It must be said that this second pillar extends the principles entailed in the Bank Resolution and Recovery Directive (BRRD), drafted by the European Council during the summer 2013. BRRD was in fact set up to break the vicious circle between banks and States, namely to avoid the bail-out of financial institutions by governments; in this regard rules were introduced for all 28 European countries to prevent that taxpayers would suffer the consequences of a bank default as it was happened during the financial crisis. Hence the burden of the recovery passes to the banks' shareholders and depositors.

The idea to establish the SRM as an expansion of the BRRD is necessary because "the SRM may face legal limitations to autonomously manage orderly resolutions of significant banks, using its own funds" (Cit. Vitor Constancio, 2014). Therefore the SRM can be seen as an extension of the BRRD in the context of Monetary Union going to trace the schemes and programs of the Directive. The common main objective is to put an end to the bail-out trend and introduce the bail-in one: instead of rescue a bank with the public money and thus shifting part of the consequences on the tax payers, this process requests the authorities to transform part of the on-going liabilities into equity with private money so as to ensure that the bank continues to fulfill its main activities. Hence a process of recapitalization and reconstruction of the balance sheet, at the expense of shareholders and creditors, is put in place without interrupting the bank

business. At this stage two kinds of resolution alternatives could be carried out: the "open bank resolution", during which in a systematic way the most distressed businesses are slowed down and reconstructed, and the "closed bank resolution", by which, instead of rebuild the bank piece by piece, this it will divided the into two smaller banks: one would be the so-called "bad bank" which will be demolished and the other, the "good bank" or "bridge bank", will continue to operate, completely cleaned from any debt and loss[38].

European authorities agreed that shareholders and creditors (according to a defined hierarchy), would be liable of financing the 8 per cent of total liabilities (own funds of the bank included) and once the losses have been absorbed, a resolution fund would be in charge of financing another 5% of total liabilities[39]. Thanks to the bail-in mechanism the intervention of the government could be rare or even never requested.

As well as the directive also the SRM will make extensive use of the bail-in instrument across the countries of the EMU, however there exist two main differences between the directive and the regulation (SRM):

In the framework of the Banking Union

- A centralized resolution authority will be set up, in contrast of a decentralized one.
- All national resolution funds will be merged into one at European level with the name of Single Resolution Fund (SRF)

The SRF will be financed *ex ante* by banks participating, and within eight years the fund will amount at least 1 per cent of the total European protected deposits. However, if necessary, the fund would receive financings also *ex post*[40].

It must be said that the SRM will not substitute the directive, which will operate in the non-euro European countries, but it will instead implement the BRRD plans and programs for the recovery; further the directive will inter into force on the 1st of January 2015, while the SRM, together with the bail in rules, exactly one year later.

Together with the SRF another important element of the SRM is the Single Resolution Board (SRB), which will be constituted by a full-time Chair, a Vice-Chair and other five members, of whom one will be representative of his country of origin. Further also one member of the European Commission and one of the ECB will be part of the Board with the role of permanent

[38] Press releases database. European Commission - MEMO/14/297

[39] Vitor Constancio (2014), "Banking Union-meaning and implication for the future of banking".

[40] "Banking Union-Single Resolution Mechanism (SRM) and Single Resolution Fund (SRF)". *Freshfields Bruckhaus Deringer.*

observers (Wolfers, Glos, Raffan-2014). The Board will be in charge of drafting resolution procedures, to execute the effective recapitalization and reconstruction and to supervise the SRF.

The ECB, through the SSM, will indicate to the Board possible distressed banks in order to let the SRB to implement the necessary resolution actions by giving specific directives on "how to act" to the country in question, even though the resolution procedures will need the permission of the Commission.

In conclusion the SRM, if well implemented, will be able to re-boost the business of the banks by recreating an environment of trust and will, at least in part, break the dual relation between banks and government, avoiding that the banks would fell under moral hazard again.

3.5) THE EUROPEAN DEPOSIT GUARANTEE SCHEME-EDGS

In the first months of 2014 European leaders have definitely agreed to set up a common supervisory mechanism with the ECB as the central institution and to form a single resolution mechanism with the SRB and SRF as predominant figures. But in order to build a Banking Union that is coherent and consistent, a third pillar is required.

The European deposit guarantee scheme (EDGS) should be able to overcome the possibility of future bank runs by restoring the confidence of depositors in the banking system. Depositors, indeed, suffer the problematic of asymmetric information; since they do not know precisely the financial health of the bank in which they invested, their actions towards it would be based on common news and word of mouth. Asymmetric information indeed would lead both to positive and negative answers: in an environment of financial stability depositors become the promoters of the financial institution, in that, ensured by the bank good performance, are confident and trust in its reliability; on the other end in the eventuality of a banking crisis outbreak, depositors will rush to withdraw their savings from the bank, causing as a consequence the spread of panic and distrust in the banking sector.[41] The distressed financial institution would thus experience a liquidity crisis caused by the multiple contemporary withdrawals and would become soon insolvent.[42]

The best solution drawn by European lawmakers to avoid bank runs is the establishment of a European deposit guarantee scheme. It will indeed assure to depositors that their savings would

[41] Maylis Avaro and Henri Sterdyniak (2013), "Banking union: a solution to the Euro Zone crisis?".

[42] Bank runs have been in fact among the main events of the 2008-crisis.

be insured up to a certain limit, even during a banking crisis; if a bank fails, savers would be reimbursed by the deposit scheme. In this context however a distinction should be made among the size of the deposits and their corresponding interest rates, in this regard in fact "relatively small deposit amounts, with interest rates incorporating no risk premium" should be guaranteed, while "other deposits, with interest rates incorporating risk premia" should not be insured and would consequently bear the risk of losses (Maylis Avaro and Henri Sterdyniak). Therefore the EDGS distinguish between simple savers, who put aside their savings and are not interested in invest them in risky assets to gain a return and investors that prefer to earn higher interest rates, but holding riskier deposits.

Another advantage of the EDGS would be the compliance of the deposit schemes across Euro Countries. Previously each member state offered its own guarantee, which could be full or partial, thus if a particular country provides full backup to savings, it would allure many depositors coming from other countries of Europe, which want to take the benefits of investing there.[43] On the contrary, with the setting of EDGS depositors "would be treated in a uniform way across countries, independently of their location and the location of the bank to whom they have entrusted their savings" (Cit. Vitor Constancio, 2014).

However, already before the EDGS, the European lawmakers attempted to make uniform, across members, the ceilings up to which deposits were insured: in 1994 the Directive 94/19/CE set EUR 20,000 per depositor as minimum amount guaranteed and that all banks should adjust to this scheme, then in 2009 the ceiling was increased to EUR 50,000 per depositor and in 2010 was raised to EUR 100,00. However, during those years, there were 40 deposit guarantee schemes in all Europe.[44] It was in 2010 that European leaders came up with the idea of establish a centralized deposit guarantee scheme, by which countries share the same provisions and ceilings, and further it would allow the banks placed in different countries to cooperate forming a network of reciprocal help, namely, in the case a bank is short in liquidity, it could requests the assistance of another financial institution in another part of the country.

The scheme will be financed by banks participating and will cover all the European financial institutions, regardless of the size and the nature, in order to avoid the run of depositors towards the only banks insured.

[43] Maylis Avaro and Henri Sterdyniak showed that this situation occurred in Irland, which implemented the strategy of full guarantee of deposits.

[44] Maylis Avaro and Henri Sterdyniak (2013), "Banking union: a solution to the Euro Zone crisis?".

3.6) ACHIEVEMENTS UNTIL NOW

Since 2012 European authority has reached many achievements and have been able, to some extents, to restore a financial equilibrium in the Euro Zone: several banks have tried to consolidate their balance sheets and sought to proceed in their activities by rebuilding step by step their credibility among banks and investors. Mr. Constancio, in this regard, pointed out that European financial institutions were lowering their liquidity buffer and repairing the ECB' s Long-term Refinancing Operations[45]. Indeed during the first months of 2014 it is clearly visible that banks are working hard to re-push the banking sector. However, despite these advances, European banking system is still fragmented and interest rate spreads persist across EMU; banks' borrowing cost in fact have not yet been harmonized and enterprises can still borrow at different rates from credit institutions[46].

Further Europe has not yet totally emerged from the recession facing higher unemployment rates, slow growth and deflation. The latter is a specific worrying consequence of the crisis because discourages investments which are one of the main drivers of economic growth.

2014 is thus a critical year, in which European leaders begin to apply the legislation regarding the Banking Union's pillars, which are a prerogative for European growth.

Major advances have been made in the realization of the SSM, in fact it will be soon implemented by lawmakers. In particular for what concerns the supervision, the Single Rulebook drafted by the EBA has already been put in action and by November 2014 the ECB will begin to supervise 128 significant banks, by monitoring their performances and completing provisions regarding the supervisory activity. However to go further in the realization of the SSM a comprehensive assessment is needed, as has been mentioned earlier through the paper. More in details the assessment is currently carried out both by the ECB and NCAs and its objective is to check the financial situation of the banks before they become part of the SSM. In other words, the aim of the authorities is to clean all banks' balance sheets in order to start from scratch under a new supervision. Consequently the comprehensive assessment will ensure "transparency and, if needed, recapitalization" (Cit. Luis M Linde-2014).

Together with a *risk assessment* of the banks' balance sheet, the assessment focuses on the two already mentioned pillars: the *AQR* and the *stress tests.* Concerning the AQR, it began to be

[45] European countries that take advantage of the LTROs were succeeding in paying back the ECB' s three-years loans.

[46] Vitor Constancio (2014), "Reflections on financial integration and stability".

carried out on February 2014 and it will be completed in August of the same year. The Stress tests instead have been implemented since May 2014 and will be terminated in September 2014 in order to already have the results by the end of October. The banks that do not pass the tests and the AQR will be put suddenly under the control of the ECB and will be requested to draw and implement recapitalization measures[47] in order to gain trust and reliability and mainly to enhance their solvency position.[48]

Moreover, before the SSM enters into force, others steps in the supervisory preparatory work should be implemented. The Regulation Framework, which set up regulations and procedures that the supervisory authority must follow, was just completed, while the ECB is currently hiring supervisors from many European countries. In this regard 8,000 applications have been sent, but still a result has not yet been achieved.

During the crisis four new institutions were created within the supervisory area and all three established to ensure financial stability as complements of the ECB: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA) and at last the European Systemic Risk Board (ESRB).

For what concerns other institutional achievements, European leaders have strengthened also the fiscal field by extending and reinforcing the *Stability and Growth Pact* as well as the *Fiscal Compact*. Both have been conceived to limit the public debt of each country, leading to the so-call austerity measures; further the Macroeconomic Imbalances Procedures (MIP) have been designed to avoid macroeconomic disequilibria and, concerning the regulatory framework, Basel III and the Capital Requirements Regulation and Directive have been extended and modified (introduction of different requirements for amount and quality of capital and new regulations on liquidity injections)[49].

About the SRM, the steps that up to now have been achieved were: on December 2013 European countries joined the Intergovernmental Agreement on the functioning mechanisms of SRF and on

[47] ECB press: "banks will be given six to nine months to address possible capital shortfalls" (12 May 2014).

[48] Luis M Linde (2014), "The Financial System ahead of the Banking Union".

[49] "Toward the European Banking Union: achievements and challenges". Speech by Danièle Nouy at the OeNB Economics Conference (Vienna-2014).

the 15th of April 2014 the European Parliament has passed the new political agreement on the SRM.[50]

In conclusion, all the previous accomplishments are the proof that the Monetary Union is trying to go further in the process of European integration, even though there have been many occasions in which European leaders and lawmakers rose doubts on the survival of the common currency. In this regard the Chair of the SSM' s supervisory board has affirmed "the political will of all actors involved since the start of the crisis has been strong enough to defend the integrity of the Euro area. Many had underestimated this will (…) today the Euro area is on a sounder footing than before" (Cit. Danièle Nouy-2014)

[50] "Banking Union-Single Resolution Mechanism (SRM) and Single Resolution Fund (SRF)". *Freshfields Bruckhaus Deringer.*

SECTION 4

IMPLICATIONS OF THE BANKING UNION IN THE EMU

FORWARD-LOOKING

In the structure of the Banking Union, what is still missing is the third pillar, the European Deposit Guarantee Scheme. While in the recent months the Single Supervisory Mechanism and Single Resolution Mechanism have been well defined and almost ready for the implementation, discussions on the EDGS are still open and doubts on its efficacy continue to exist. European leaders have not yet determined if to apply the rules of the scheme at EU level or if only the Euro Zone countries are required to follow the regulation.

Another concern is related to the common fund for deposits both on the financing problematic and on its size: some European countries, specifically the Northern ones, still question the solvency of the banks placed in Southern Europe such as Spain, Portugal and Italy, hence they prefer to not bear the costs of a common fund before the trust in those banking systems has been restored. Further European authorities have not yet determined if the fund will be supported ex ante or ex post by financial institutions[51]. With regards to the size, namely the amount of money saved in the deposit the fund would be able to reimburse, the solution has not yet been reached since banks' contributions ex ante would not be sufficient to recover depositors in the event of a crisis and thus it would shift the burden again on the States. Therefore the fund reserves should be indefinite in order to guarantee all taxpayers' deposits up to EUR 100,00, but German authorities refused such proposal and believe that the only answer would be to finance the fund ex post by banks looking at the degree of the crisis, but even this solution is still uncertain.

Further, European leaders have not yet agreed on which organization will be managing the fund and in this case the ECB might not be selected since it would be already in charge of supervising the banking sector and the administration of the fund would conflict with its role of lender of last resort.

The design of the EDGS thus is still confused and imprecise and it faces significant challenges, but it must be said that the importance of such a program must not be underestimated and

[51] Maylis Avaro and Henri Sterdyniak (2013), " Banking union: a solution to the Euro Zone crisis?".

questioned. When in the next years the SSM and the SRM will be operating, it is unconceivable that a bank would have to apply different programs to depositors in its subsidiaries across the Euro Zone. In other words the objective of the European authorities is to avoid that banks, joining the SSM and the SRM, apply different guarantee schemes and charge divergent interest rates on deposits.

This is why, to have a complete and coherent Banking Union, it would be important to make a supranational deposit guarantee, regardless of its limits and challenges.

One might ask at this stage what is the meaning of the Banking Union for the Euro Zone and which are the real benefits it could bring to the European economy; further it must be specified that the beneficiaries of the following advantages will be the states which join the EMU, but even the non euro countries (called the “outs”) have the option to join the Banking Union at any time[52].

First of all an integrated banking system will restore confidence in the banking system by avoiding the fear that national governments, in place of centralized institutions, would bear the costs of a banking crisis. To illustrate this it would be useful to employ a comparison between Ireland and Nevada reactions to the outbreak of the financial crisis. Until 2007, these two countries displayed analogous attributes such as levels of population and of GDP. Further they both experienced the housing boom and its crash, which led to similar unemployment rates.

FIGURE 3: IRELAND AND NEVADA COMPARED (2011)-Eurostat and BEA, US Census Bureau

Table 1. Ireland and Nevada compared

	Nevada	Ireland
Population (in million, 2011)	2.7	4.5
GDP (in $ billion, 2011)	120	200
Average net migration rate since ‘bust’ (2008) as percent of total population	0.32%	0.09%
Unemployment rate (2011)	13.5%	14.4%

Sources: Eurostat and BEA, US Census Bureau. [53]

[52] For example the United Kingdom and Sweden have already refused to adhere to the Banking Union.

[53] Source: Eurostat and BEA, US Census Bureau

The only significant difference between Ireland and Nevada is linked to how the banking system has been affected by the crisis: while the Irish government has been obliged to bail out some of the distressed financial institutions causing a destruction of the banking sector and a subsequent loss of confidence in it, in Nevada the latter has not happened and only some banks became insolvent without the need of been rescued. The reason for this difference is that the State of Nevada is part of a full banking union, hence banks' problems and failures are solved at federal level and not at national. In this regard the Federal Deposit Insurance Scheme (FDIC) in US, which is a supranational institution, is in charge of cover the losses. On the contrary, at the time of the housing bubble a European banking union had not yet been created and national authorities were responsible for banks' losses, but they were not strong enough to face the huge debts of the banks. As a consequence the banking sector suffered and defaulted[54].

A second benefit that the Banking Union could bring refers to the financial trilemma by Shoenmaker. By adapting the banks' supervision and the crisis resolution to a centralized context, the trilemma, whose principles had been violated during the crisis, would be observed. In this regard, national monetary policies would be left out, allowing financial stability and integration to be pursued.

Moreover European banks, to fall in the requirements set by the Banking Union, began to repair their balance sheets, restoring, as a consequence, confidence in the credit channels. In fact European financial institutions have started to increase capital and decrease liabilities in the balance sheets, by deleveraging their assets position. These "cleaning" measures, in addition to the comprehensive assessment carried out by the ECB, will be able to rebuild confidence in the banking sector, leading to a defrosting of the credit activities. Banks in fact will believe again in one another, strengthening the cross-border activities and the inter bank market, already well integrated before the crisis[55].

Another important advantage to mention is the possibility for the ECB to pursue again a coherent monetary policy across the member states. This will be possible because the establishment of the SSM and SRM would set a uniform set of rules and standards that all banks has to follow, allowing in the long run the convergence of rates between peripheral and core countries. Hence banks will be able to respond in a similar manner to the measures taken by the ECB. In fact the

[54] Daniel Gros (2012), "Banking Union: Ireland vs. Nevada, an illustration of the importance of an integrated banking system".

[55] Vitor Constacio (2014): "this development (rise in confidence) has been recognized by the stock market where banks' share prices increased by 41% in 2013, above market average growth of 20%"

objective of the European authorities and specifically of the ECB is to focus more on macro-prudential policies and less on the micro ones in order to safeguard the stability of the financial system as a whole and not the one of individual banks. Macro-prudential policies, complemented with the micro-prudential ones, will allow the ECB to smooth the differences existing between financial institutions placed in different countries and to restore a uniform transfer of the monetary policy.

Since an integrated financial system will foster competitiveness among banks and will re-boost the lending activities, the demand of firms for funding, which during the crisis could not borrow high amounts of moneys by credit institutions, will increase, leading to higher productivity and growth.

Once the Banking Union will be operating, it will be created a system of banks even more integrated than the one characteristic of the years prior to the crisis because, as already mentioned, banks will rely on each other and will be supported by a supranational institution, thus this mutual trust would "optimise their internal management of capital and liquidity and reduce compliance costs" (Cit. Vitor Constancio-2014). As a consequence there will be capital movements in the European banking sector, increasing financial economies of scale and scope.

The banking Union would also strengthen the role of capital markets regarding the lending activity. Following the model of the market-oriented economies such as US and Britain, European authorities have agreed to allow banks to hold more liquid assets such as bonds and securities. Thus the credit institutions will be able to finance both through loans, which are considered as illiquid assets, and through financial instruments, traded in the stock exchange. The nature of the credit institutions will thus change from commercial banks to investment banks, which will finance firms and individuals both through loans and bonds. In this case, in the event of a banking crisis, banks would be capable to transfer sufficient levels of credit to the economy[56], without worrying of a temporary lack of liquidity.

Lastly, the Banking Union would be effective in breaking the feed-back loop between banks and states and actually this is one of the reasons for which it has been designed[57]. Because of their nature, the SSM and SRM will be able to loosen the relationship between credit institutions and governments, by making the business of the banks independent from the one of the states. However the two pillars alone are not sufficient to eliminate the critical vicious circle. First of all

[56] Vitor Constancio (2014): "Banking Union-meaning and implications for the future of banking".
[57] As it was mentioned and explained in section 1.

because the real benefits of a centralized supervision are not yet known, hence as Mr. Constancio during one of his speeches pointed out, the effects of a supranational supervisory authority could be more limited than expected, on the other hand the SRM power could be restricted because of the scarcity of funds necessary for banks' recapitalisation. As a consequence has emerged the need of a genuine fiscal backstop (not affecting the government current account), both at national and European level, in the case in which the bail in measures and the resolution fund would be unable to recapitalise and restructure the banks in trouble.

Already on the 26th of June when the report of Van Rompuy, President of the Council, was drafted, European leaders agreed on the possible intervention of States as a last resort. Within the framework of the Banking Union, indeed, they set the process through which banks, needing capital (capital shortfall), would be recapitalised. This procedure has been formalized on the 10th of June 2014 at the council of the Eurogroup and ECOFIN: in a first instance banks will need to prepare restructuring plans on private basis, by applying the bail in measures, that is a maximum amount of 8% of total liabilities, together to 5% deriving from the Single Resolution Fund. If these actions prove to be insufficient, member states have to intervene with national backstops. Therefore within November 2014 all states are requested to create their own national backstop through the establishment of a rescue fund. If the actions of the sovereigns are insufficient as well, then the European Stability Mechanism (ESM) can step in by lending funds to the interested member states.

The ESM was established as successor of the EFSF[58] in October 2012 with the objective of "providing financial assistance to euro area Member States experiencing or threatened by financing difficulties" (Cit. ESM). It is a standing resolution mechanism, which *via* the issuance of debt instruments, support and provide loans to Euro countries.

An *indirect recapitalisation* is put in place in the case in which the ESM finances the State, which in turn transmits the loan to the distressed bank. But even this measure could not be effective if the State is unable to restructure the bank with the ESM's funds. Hence, as last resort, at the very end of the process, the ESM will be asked to intervene directly, providing funds to the bank without passing through the state (*direct recapitalisation).* In this regard in the Council of the 10th of June, the Eurogroup and the ECOFIN ministers have agreed on the procedures that ESM should follow when the direct recapitalisation is needed (European backstop), further it has been

[58] Recall note 22 of section 2 on the EFSF.

stated that the ESM will be able to recapitalise only the "systematically important" financial institutions, which are under the direct control of the ECB. Again, the European and national backstops will be contemplated only at the end of the process. The bail in of creditors and shareholders together with the reserve of the Single Resolution fund, in most of the cases, would be sufficient to recapitalise the bank and address its losses[59].

However the Member States, in order to have access to the ESM resources, will be asked to sign an agreement with the European Commission, the ECB, the ESM and if necessary with the International Monetary Fund (IMF).

The fiscal backstop, used as a last resort, shows that euro area countries are willing to share their sovereignty with the others Member States, in that supervision and resolution will be transferred at European level. In fact, trying to prevent public intervention as much as possible, and sharing their sovereignty, European States are showing to be committed to the European integration project and willing to strengthen the Monetary Union.

To forecast the benefits of this procedure, one might look at the US, which has implemented a similar mechanism: the FDIC, when the private fundings to restructure banks are not sufficient, has a line of credit with the Treasury whenever it needs to have access to liquidity in an emergency case. The Treasury loans are reimbursed in a second moment with interests. During the years of the crisis the FDIC, in order to rescue banks in trouble, often activated such line of credit and it was able to pay off more than 400 credit institutions, in contrast of the 20 liquidated by Europe. This is the reason why the Single Resolution Board should have a constant line of credit with the ESM.

The ESM intervention as a new instrument, although requested at the end, has become part of the Banking Union framework, alongside the SSM and SRM[60]. Further the necessity to add the *direct recapitalisation* to the process and not stuck to the indirect one, is a consequence of the fact that Member States, to repay the ESM loans, would contract new debt, threatening to fall again in the feed-back loop between banks and states. In this case, instead, it would be possible to recapitalise credit institutions without shifting the burden on the governments' accounts.

In this regard many conceived the implementation of the ESM as the tool that most could avoid the loop between banks' debt and sovereigns' debt, however the real breakthrough brought by

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[59] Vitor Constancio (2014), "Banking Union and European integration".

[60] Statement by the President of the Eurogroup " ESM direct recapitalisation instrument", at the Council of the 10th of June 2014.

the European authorities was to design a complete architecture comprising the SSM and the SRM and SRM, both complemented with a genuine fiscal backstop.

4.1) BROADER RESULTS-THE SECOND BEST

A part from the concrete benefits the Banking Union would bring to the European Monetary Union, it would be interesting to look also at its broader effects on the area. The purpose of this sub-section is to analyse what Banking Union implies in a broader context and especially its meaning both for EMU and EU when compared with the rest of the world.

Europe is the so-called "old-continent", the navel of the world thanks to its strategic position. Even looking at the map, one can realize that it is at the centre of the globe and till recently its economic performance has been merely at the same level of all developed countries around the world. However, in the last years its economic growth became to decline, overtaken by new emerging countries, which, on the contrary, were able to adapt to the contingencies required by fast-changing environment.

Hence, one might ask what was the problem faced by the continent of last twenty years. Europe remained old and rooted in the achievements of the past and not directed to the future. During the years of 2000, it has not been able to renew, to innovate and to catch up the incredible speed of the rest of globe.

A possible explanation could be the fact the Europe and, in this context, EMU are both not yet really united and integrated and consequently they are unable to exploit the huge resources that each European country could offer. In 1992 the European Union and the EMU were formed, and in 2002 the common currency began circulating in the Euro Zone (now comprising 18 countries out of the 28 of the EU), however, after the constitution of the Euro, no significant advances have been made to support the integration process and to foster the growth of the continent. The beginning of the European integration can be traced back to the 50s when, after the World War II, countries recognized that they should have been joining together, in order to recover the damages caused by the war and to reconstruct their economies. In 1948 indeed the first European institution was established, the OEEC (Organization of European Economic Cooperation), the grandfather of the European Union.

Following its creation European authorities tried to go further in the integration process with the objective of creating the "United States of Europe", advocated by the Italian Altiero Spinelli in his "Ventotene Manifesto", but this aim however has never been reached. It was thought that the

creation of the monetary union would have spur a comprehensive economic union, but this did not happen. Countries and citizens do not feel European, but rather they consider themselves "Italian", "Spanish" or "German". This lack of "Europeanization" was not what the fathers of the European integration aimed to and dreamed to. Indeed, after 1999 (creation of the euro), no relevant improvements have been done because the European authorities thought that the achievement of a common currency was enough to reach a real European financial market.

It might seem ambiguous, but the financial crisis has led to one good thing: it has brought back the enthusiasm of going further in the integration process. Even though the report written by Van Rompuy was conceived for necessity rather than a desire for its own sake, it has been the first real success after the creation of the common currency. The crisis, indeed, has shown that countries, although unified around the EMU, were not able to face it and recover their economies in a powerful way, making clear that the initial design of the union was not totally correct. The negative contingencies made clear an incredible paradox: crisis has quickly spread to all EMU because of the highly interconnected and integrated banking system, in that banks of a country strongly relied on banks of another country[61], but once decisive reforms to face the crisis were requested and when the economies of the states began to decline, each government responded independently seeking the interests of the country and not the ones of the European community and the European banking system. As a consequence European authorities, as well as the ECB, were no longer able to pursue a coherent monetary policy across the Euro Zone and the measures to recover the banking sector were ineffective. It was shown the EMU lacked the necessary institutions to face the crisis, in particular a such integrated banking system would have required centralized institutions, that would have implemented systematic and uniform actions to recover the economy of the Euro area as whole. As a matter of fact European authorities, during the wave of the crisis, began to put effort in building the prerequisites of a truly union. They started to recognize that Europe needed more. The most effective solution to the crisis would have been to implement a program comprising a series of steps to build the foundations of a genuine economic and political union. It is in this context that Banking Union is placed, which is the most reasonable answer and the starting point for a comprehensive economic union.

[61] Interbank market

To become competitive and to outperform the rest of the world and especially the emerging countries, Europe should become a "federation of states" and not "a group of states". As for the United States of America, European Union should become the "United States of Europe" with common banking, fiscal and political procedures. Countries should believe in this project, promising mutual assistance in the case of future negative shocks and national governments, in this regard, should rely on and support European authorities by leaving part of their power to supranational institutions, which would act for the welfare of the Union. Only in this way the "old continent" would emerge as a "new continent", able to compete with developed and developing countries, such as the four Asian tigers,[62] China and Brazil that are now the new protagonists of the global growth in an extremely competitive environment.

The Banking Union will have a huge impact on EMU and Europe, considered as the first real milestone after the crisis and able to give to Europe the necessary strength to compete with the rest of the world.

If European countries in the future will be able to cooperate and to integrate, their specificities and resources would merge and finally citizens would fell European. If Banking Union will work in the future, it will be the proof that countries want to be part of a broader context and this would give an incentive to the authorities to go further in the process and to undertake the next steps, namely a fiscal, an economic and political union[63]. In the following years, indeed, it will be clear if a centralized supervision and a common resolution mechanism will operate in an effective way and if a common guarantee scheme of depositors will be set up.

At this stage of the process it would be hard to readjust or even go back. In the last months there have been a large number of meetings, there have been created institutions and defined plans have been set up. European authorities believe in this design and most of them is sure enough that this big step towards a closer integration will be realized. The report of June 2012 should serve as a basis for the future and should guide the authorities on the road to the political union. If the pursuing of common policies will work, Europe would be able to absorb much more shocks and a country in trouble such as Greece, which is worth the 2 per cent of the European GDP, would no longer cause huge imbalances and threaten the economy of the others member states. As well for the Ireland-Nevada case mentioned above, in that US, thanks to its high degree of integration, was able to cope with the crisis in a faster and effective manner.

[62] Singapore, Hong Kong, South Korea and Taiwan.

[63] Recall the report "Towards a genuine economic and monetary union", by President Van Rompuy.

However, what would be the consequences for the Euro Zone countries if the project of the Banking Union fails? What would be the alternative that European authorities could undertake in the event of a failure of the project?

In the framework of the monetary union a second best does not exist. Member states will have to exit the Monetary Union and abandon the Euro by coming back to their previous currency, remaining however in the EU community.

The explanation of this radical alternative can be derived by the financial trilemma of Shoenmaker. According to the trilemma financial stability, financial integration and national financial policies cannot operate at the same time. Since the creation of the Euro, financial stability and financial integration, at the expense of the nations' sovereignty, were functioning. But if the banking union project fails, this means that European leaders have not succeed in integrating the banking system in a uniform way, as a consequence the centralization of powers does not work and the ECB and the banking union mechanisms are not able to pursue a common and coherent policy across the banks of Euro Zone. Financial national policies will consequently prevail, leading to the choice between financial stability and financial integration. The latter has failed due to the breakdown of the banking union and since financial stability is the most important objective to pursue and to preserve, this will be maintained and transferred at EU level from EMU level. Therefore, if it will no longer be possible to pursue common policies, and the best alternative in this scenario would be to maintain financial stability together with national financial policies, at the expense of the financial integration based on the common currency and prerogative of the European Monetary Union.

Hence the suggestion would be to push strongly to complete the three pillars of the Banking Union as fast as possible and consequently the European authorities should implement this project in a systematic and productive way in order to make the outcomes more efficient and effective.

However this could not be enough, because it would be fundamental to supplement the Banking Union with a central fiscal authority, whose objective would be to ensure a centralized fiscal regulation at European level. The main task of this authority would be to support the fiscal policies of Euro Zone governments aimed at enhancing growth and competitiveness. This would be carried out through transfers of funds across Member States and through the issuance of debt and taxes at European level.

Of course the establishment of a central fiscal authority needs a strong political agreement between the countries, much stronger than the one needed for the creation of the Banking Union.

CONCLUSIONS

The Banking Union arose from the need, highlighted by the crisis, to complete the Monetary Union framework. The crisis, indeed, posed serious shortcomings in the original design of the EMU, showing how still fragile was the Union during the outbreak of the financial crisis in 2007. In that period of financial instability European authorities were unable to respond to the crisis in an adequate and effective way. The weakness laid in the fact that EMU was lacking of robust supranational institutions, whose objective would have been to control and reconstruct the European financial institutions in a systematic and ordered manner. Since the EMU economy was based to a large extent on the banks' lending activities, when the crisis fragmented dangerously the banking system, the first requirement to be met was to create an *integrated financial framework*. European authorities, indeed, agreed on building up a Banking Union to ensure financial stability, by shifting bank supervision from national to supranational level and by establishing a common resolution mechanism aimed at reducing banks failures' costs and at resolving the crisis with a common procedure across credit institutions. In the future, in order to go forward in the integration of the banking sector, a common insurance scheme of depositors and a genuine fiscal backstop, implemented by the ESM, will be set up.

The comprehensive analysis of the Banking Union, throughout the paper, has shown its effectiveness in solving, or at least mitigate, the problems and challenges brought by crisis and faced by the banking sector. Chief among them, the dangerous loop between bank's debt and sovereign's debt. European authorities recognized that the EMU needed a common supervisory mechanism and resolution mechanism in order to shift the burden of the banks' insolvency from the national governments to the European one, through the establishment of a common resolution fund, in order to eliminate the possibility that states would incur in large accounts deficits. One of the main objectives, indeed, is to avoid that domestic taxpayer would pay the consequences of the banks and states losses and to prevent, by recapitalising banks' balance

sheets, the insolvency or failure of financial institutions, which consequently would result in massive bank runs.

The ECB and the European authorities are trying to create all the prerequisites to sustain a genuine economic monetary union, in order to make converge and cooperate all the participating countries. It seems that European institutions together with national governments are proceeding in the right direction, being engaged to create a stronger and competitive Monetary Union. Since the drafting of the report by Van Rompuy, big achievements have already been done. The SSM, first pillar of the Banking Union, will soon start operating (November 2014), the SSM's comprehensive assessment, task of the ECB, is currently in execution, and banks have began to reconstruct their assets and recapitalize their balance sheets. Hence the fundamentals basis to construct the desired financial, fiscal, economic and political union, drawn in the report *"Towards a genuine Economic and Monetary Union"* by Van Rompuy, have been set and are under operation.

The financial crisis has brought the enthusiasm of going ahead in the monetary integration process and now it is the right moment to exploit this "political impetus" towards the creation of the so much advocated "United States of Europe". The Banking Union is in fact seen as equally important as the creation of the Euro, for its meaning and for the promises that brings with it. It is important, indeed, to prevent the risk that this project would fail, before been completed, and European and national governments should avoid leaving halfway the process of integration, as happened after the establishment of the common currency. In this case the consequences would be strongly negative because the EMU would be exposed again to the danger of future crisis, undermining the EMU and its survival.

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