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Designing a Genuine EMU: Which "Unions" for EU and Eurozone?

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EUROPEAN ECONOMIC STUDIES

Bruges European Economic Policy Briefings 34 / 2014

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Designing a genuine EMU:

Which "unions" for EU and Eurozone?

Jacques PELKMANS[1]

Abstract

The initial 'framing' (in the summer of 2012) of the 'genuine EMU' for the wider public suggested to design an entire series of 'unions'. So many 'unions' are neither necessary nor desirable – only some are and their design matters. The paper critically discusses first the negative fall-out of the crisis for EMU, and subsequently assesses the fiscal and the banking unions as accomplished so far, without going into highly specific technical details. The assessment is moderately positive, although there is ample scope for further improvement and a risk for short-term turbulence once the ECB has finished its tests and reviews.

What about the parade of other 'unions' such as economic union, social union and political union? The macro-economic imbalances procedure (MIP) and possibly the ESRB have overcome the pre-crisis disregard of macro competitiveness. The three components of 'economic union' (single market, economic policy coordination and budgetary disciplines) have all been strengthened. The last two 'unions', on the other hand, would imply a fundamental change in the conferral of powers to the EU/ Eurozone, with drastic and possibly very serious long-run implications, including a break-up of the Union, if such proposals would be pushed through. The cure is worse than the disease. Whereas social union is perhaps easier to dismiss as a 'misfit' in the EU, the recent popularity of suggesting a 'political union' is seen as worrisome. Probably, nobody knows what a 'political union' is, or, at best, it is a highly elastic notion: it might be thought necessary for reasons of domestic economic reforms in EU countries, for a larger common budget, for some EU tax power, for (greater) risk pooling, for 'symmetric' macro-economic adjustment and for some ultimate control of the ECB in times of crisis. Taking each one of these arguments separately, a range of more typical EU solutions might be found without suggesting a 'political union'. Just as 'fiscal capacity' was long an all-or-nothing taboo for shifting bank resolution to the EU level, now solved with a modest common Fund and carefully confined but centralised powers, the author suggests that other carefully targeted responses can be designed for the various aspects where seen as indispensable, including the political say of a lender-of-last-resort function of the ECB. Hence, neither a social nor a political union worthy of the name ought to be pursued. Yet, political legitimacy matters, both with national parliaments and the grassroots. National parliaments will have to play a larger role.

JEL codes: E02, O47, N24

Key words: Economic and Monetary Union; Banking Union; Political Union; Financial Crisis.

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1. Introduction and structure

Ever since the 1970 Werner report, it is customary to utilize a single term to characterize the EU as an economic construct: the Economic and Monetary Union (EMU). Of course, initially EMU was a distant ‘dream’. For two decades following Werner, it looked more like a ‘fata morgana’. This changed with the EC-1992 programme for the single market and the 1989 Delors report on EMU. Today, 25 years after this daring report, some two-third of the EU lives and works under an EMU regime. EMU is invariably supposed to include the single market and what is today the Eurozone. Both components have been pursued on the basis of a host of expected economic benefits which were expected to be further enhanced when the two parts were combined from 1998 onwards.

When in May 2008, the EU celebrated “euro@10”,[2] EMU seemed to work. Empirical economic analysis was capable of demonstrating some first economic benefits (besides shortcomings, to be fair). There was a reasonable expectation that, gradually, more EU countries would join the Eurozone, although doubts remained with respect to the UK and Sweden. Little did EU policy makers knew what would follow barely four months later. The financial, sovereign debt and economic crisis amounted to an existential test for EMU. It revealed significant design flaws as well as shortcomings in its implementation. After first addressing the most obvious regulatory weaknesses and desperately attempting to fend off one financial market panic after the other, the fundamentals of EMU had to be re-considered seriously. Difficult and sensitive strategic choices became inevitable for national governments and the EU institutions. A new and better EMU had to emerge from the ashes of EU’s triple crisis. In the summer of 2012 the European Council began to focus on a “genuine EMU”. Whatever such a ‘genuine EMU’ might be, it strongly suggests that the EU leadership was searching for the ‘optimal economic design’ of EMU.

The present paper discusses in a non-technical manner how this optimal economic design was ‘framed’ and communicated, and whether and to what extent this ‘genuine EMU’ makes economic sense for the EU. The initial ‘framing’ for the wider public suggested to design and pursue four ‘unions’, but in fact no less than six or seven! It will be shown that such an approach does not represent ‘optimal economic design’ as so many ‘unions’ are neither necessary nor desirable – only some are and their design matters a lot.

Section 2 notes that a ‘genuine EMU’ is of cardinal importance, but that its framing had the effect of overselling it: it does not imply a parade of unions. Section 3 illuminates the negative fall-out of the crisis for EMU. If EU policy makers wish to avoid the discrediting of EMU by voters, the only alternative is to go for the enormous ambition of building a ‘genuine EMU’. Section 4 takes the view that the fiscal union is more or less in place by now. Because the EU has an EMU design where monetary policy is centralized fully, whereas (for profound political and constitutional reasons) fiscal policy remains national but under EU constraints, there is no point in asserting that fiscal policy ought to be centralized. It is therefore crucial to clarify as well what the EU fiscal union is not! Where the EU (or Eurozone) level requires

[2] European Commisssion (2008); Buti, Deroose, Gaspar & Martins, ed.s, 2010

modest fiscal instruments of its own, credible solutions can be found without impinging more than marginally upon national fiscal sovereignty. Section 5 discusses the EU banking union and some of its technical details. The banking union is far from perfect and likely to be improved/ deepened over time. Section 6 is about serious EU issues connected to EMU, but which do *not* need 'unions' to address them properly. Section 7 concludes.

2. Genuine EMU, important, yet oversold

In the summer of 2012, EU strategic thinking began to take over from panic management and painstaking efforts to regain minimum confidence in financial markets. The EU and the Eurozone in particular, had:

(i) bravely faced four years of permanent or newly erupting crises (addressed via new EU funds and tight 'troika-led' control and oversight for the relevant EU countries, besides greater stringency of the Stability & Growth Pact and tougher role of the EU EcFin Commissioner);

(ii) engaged in frantic legislative activity on bank solvency rules, supervisory 'standards' (especially capital requirements), registration and monitoring of financial market players left free before (e.g. credit rating agencies; asset managers), bank bonuses, state aid for banks and counterparties for 'derivatives' trade (enhancing stability);

(iii) introduced institutional changes hitherto taboo such as turning EU supervisory committees into EU Agencies, widening the powers of the ECB and establishing the European Systemic Risk Board.

The Eurozone had barely been rescued and was still fragile at best. The most vicious aspect was the 'deadly embrace' of weak sovereigns in need of banks acting in support of them (by buying or keeping their bonds) and weak – in some cases, near-insolvent - banks loaded with depreciated government bonds of several Eurozone countries. This created a 'doom loop' that had to be broken for good. Would such banks be seen as no longer solvent, yet 'too big to fail' in the relevant country, the sovereign would have to come to the rescue, thereby further weakening its fiscal sustainability, causing higher interest premia, in turn undermining its fiscal position still more. The banks were deleveraging, but this very slow process (in a crisis) hindered them in giving credit or rolling over existing loans, causing the crisis to perpetuate.

The EU internal market for financial services is now underpinned by wider and a more appropriate regulatory regime, but the damage of the crisis turned out to be severe: (i) a dried-up interbank market, (ii) (some) cross-border banks that had been ripped apart along national lines and (iii) increased financial market fragmentation together with massive repatriation of assets, the very opposite of what ought to underlie a monetary union.[3] Moreover, there were lingering doubts whether the institutional changes were sufficient or

[3] See e.g. Sapir & Wolff (2013), Gros (2013e), IMF (2013) and ECB (2013)

credible for market players. A number of institutional reforms at EU or Eurozone level are intergovernmental and hence notoriously inefficient.

Thus, in an unusually candid interview, Mr. Andrea Enria, Chair of the European Banking Authority (the new Agency in charge of supervision), complained bitterly about hopeless inter-governmentalism in bank supervision and resolution: “..the benefits of crucial stress tests…could be impaired if decision-making were not streamlined and nationalist tendencies contained. The EBA has to move away from consensus-based governance traditions… You need European decision mechanisms rather than having always a committee-type of decision in a crisis. Committees in a crisis don’t work because you have conflicts.”[4]

The basic proposal for a ‘genuine EMU’ was designed in the summer of 2012[5]. However, van Rompuy framed this ‘genuine EMU’ as the result of four ‘unions’: fiscal union, banking union, competitiveness union and political union. On the face of it this sounds more precise than the traditional wisdom of improving the “E” of EMU, its ‘economic union’. With the message of van Rompuy, one might be led to think that the E of EMU was decomposed into three specific ‘unions’ complemented by a ‘political union’.

However, upon reflection, one discerns that this framing is not convincing. First, EMU itself consists of two unions, economic and monetary, both treaty-based, and none of these other ‘unions’ are mentioned in any EU or intergovernmental treaty [6]. Should this be interpreted as the replacement of ‘economic union’ which is anyway barely elaborated in the treaty, if not left undefined? If not, what then is the relation of the E of EMU with this new parade of ‘unions’? Second, nobody knows what a ‘political union’ is. There is a giant literature on the idea, but it is splintered into many directions. This is not to say that EMU and its implications are somehow a-political. Of course they are not, but the core issues are about political legitimacy and there are many ways to address this (see section 6). Third, the ‘competitiveness’ union would appear to be a misnomer as will be shown in section 6. Finally, there is some debate in Europe about a ‘social union’ or at least, much greater priority for the social dimension of EMU. Again, a social union is deeply flawed for the EU of today, the importance and sensitivity of social aspects notwithstanding. This fundamental question will be dealt with in section 6.

A ‘genuine EMU’ needs three ‘unions’, each with different degrees of centralisation: monetary union, fiscal union and banking union. In addition, secular imbalances over the current account create exposure risks possibly causing – in particular in the case of a ‘sudden stop’ of external finance – extreme disruption, with the upshot that the adjustment (of deficit countries) falls entirely on the demand side via contraction (as nominal exchange rate adjustment is no longer available). This relates to serious issues of systemic risks and

[4] Financial Times, frontpage, November 18, 2013. He also noted that “…it was vital that more power was devolved to EU institutions…They [EU lawmakers, JP] give us responsibilities but they put so many national safeguards on every task… that sometimes I am concerned we will not be able to perform them.”

[5] The reference in footnote 6.

[6] This is probably why the official submission to the European Council by the four presidents carefully avoids the term ‘unions’. Instead , they employ ‘frameworks’ and architecture. See ‘Towards a genuine EMU’, report issued on 25 June 2012, president European Council, SN 25/12. However, the non-technical debate in the EU is often framed in terms of ‘unions’. For a typical advocate of this approach, see Maria Joao Rodrigues (2013).

financial instability, hence to be addressed in a credible and durable fashion. The combination of the macro-economic imbalances procedure (MIP) and the European Systemic Risk Board (ESRB), with some incentives in the margin as well, should be capable of preventing irresponsible bubbles or at the very least lead to ‘alerts’ which should cause financial markets to ‘price in’ the risks, whilst the Eurozone level will insist on reforms and eventually sanctions. A ‘genuine EMU’ also generates major issues of political legitimacy, hence, involvement, inclusiveness as well as transparency should not be taken lightly (see section 6).

What a ‘genuine EMU’ does *not* need is a parade of ‘unions’ as discussed above. It confuses the debate and tends to oversimplify the policy choices. It also creates a danger of suggesting that the EU or the Eurozone turns into an ever larger collection of (presumably centralized) ‘unions’, or, becomes a fully-fledged federation or a super-state, neither of which are desirable nor necessary. With fairly modest and selective limitations of national policy autonomy and specific, well-justified instances of centralisation, EMU can function properly. The only structural and difficult question is that not all the EU is in the ‘genuine EMU’ whereas all 28 EU countries are in the single market.

3. Negative fall-out of the crisis for EMU

The ‘Great Recession’ has severely affected the EU economy and EMU in it. The flaws of and gaps in the EMU regime have worsened the crisis everywhere in Europe but especially in the weaker Eurozone countries. The ‘genuine EMU’ must have the capacity to better address future recessions and its design, rules as well as institutions ought to be able to help Eurozone countries to weather a crisis, not worsen it. Before discussing in some detail what the EU fiscal and banking unions imply, it is useful to give three reminders of how the crisis revealed shortcomings and flaws of the ‘incomplete’ EMU’.

3.1 The EU versus the Eurozone

The very term ‘EMU’ can only be reconciled with the EU as a whole if one assumes that the ‘outs’ (EU countries not part of the Eurozone) are ‘on the way in’. If some countries stay out for ever (i.e. the UK and Sweden) and/or if the road to euro membership is very long for some other countries, complications inevitably arise.

The common element is the single market. The ambition to further deepen the single market received a boost with the introduction of the euro, in particular for financial markets. Nevertheless, financial markets and certainly retail banking have not been fully integrated before the crisis: bank mergers typically remained national, with some exceptions, mortgage markets are fragmented even inside the Eurozone and retail services are largely national. With the coming of a ‘genuine EMU’, the question is whether the ‘outs’ are willing and able to join a renewed ambition of deepening financial market integration. In the case of supervision, the choices are starker still.

As section 5 describes, the new supervision architecture in the EU (not just the Eurozone) is based on centralisation, which (before the crisis) had always been resisted by EU Member

States. The first step was the establishment of three EU Agencies on banking (EBA), insurance and securities services (ESMA). Although this should long have happened in the 1980s or 1990s, without the crisis revealing sharply that supervision had failed both nationally and in terms of inter-Member-States' cooperation and trust (in particular, in the Eurozone), the three Agencies would simply not have come into being.

The UK filed a case[7] before the EU Court of Justice on the one and only instance where one of these Agencies (ESMA) has a (conditional) emergence power (on stopping short-selling). The legal basis is Art. 114, EU (the internal market & harmonisation article), implying that qualified majority voting did suffice to pass the Regulation on ESMA. The reader is reminded of the bitter complaints of EBA Chair Mr. Enria about excessive inter-governmentalism in these Agencies. Had Art. 352, EU, been used instead, the UK would have vetoed this emergency power of ESMA or would have added safeguards that might frustrate quick action in rapidly moving financial markets. In other words, the centralisation - meant to overcome ill-functioning and slow committees as well as lack of trust - is still at risk of being undermined.

However, in banking the problems for the Eurozone are so urgent and large[8] that further centralisation became respectable in the Euro group. The rationale of transcending narrow-minded and captured national supervisors would both improve quality and – in one stroke – ensure the EU public interest, including the pre-emption of contagion and the protection of financial stability. The point is not new and had long been advocated by academics and think-tanks. It applies as well to the 'outs' and some of them will join the newly centralized supervisory system which is open to all EU countries. But some will not, yet they have every interest to influence the design and operationalization so that the internal market for banking services is well served, without any Eurozone bias. These issues are more difficult than when EBA was established, which is clearly an EU-wide institution for the internal market. However, supervision cannot be credible without bank resolution powers. Therefore, the 'ins' versus 'outs' discussion has become more burdened with the ambition of having an EU (or Eurozone) bank resolution Agency with funds, backing up resolution when banks are no longer solvent (given supervisory prudential requirements). Logical though it is to Europeanise resolution together with supervision, the national sensitivity about bank resolution is great. Still, the Eurozone countries are willing to go far and have entrusted 'their' ECB (although the ECB is an EU body!) with supervision of the largest banks, while taking the lead in the design of new EU institutions tasked with resolution. The solution found for the 'ins' versus 'outs' discussion is based on a number of safeguards which, altogether, would seem to be appropriate [9].

[7] The ESMA case boiled down to the UK's insistence that the ESMA power to stop short-selling (under strict conditions) violated the Meroni doctrine. The CJEU rejected this claim on 22 January 2014. Case C-272/12, not yet reported. See Pelkmans & Simoncini (2014) for a further analysis.

[8] But not only in the Eurozone, of course. In Central Europe and the UK (Northern Rock; several mortgage banks; Royal Bank of Scotland) very serious banking issues emerged early in the crisis, not to speak of Iceland which is in the EEA, hence in the single market of financial services.

[9] Following the Commission's summary, there are six safeguards : (i) the Banking Union is based on the single rule book (for supervision and prudential requirements) for the entire single market ; (ii) although the notion of

But there are other 'divides' between 'ins' and 'outs', especially when it comes to the outs from Central Europe. The 'outs' from Central Europe are under the treaty obligation to enter the Eurozone one day. Before the crisis, this predicament generated a willingness to join or align domestic policies or (e.g. internal market) strategies with the Eurozone, especially on the basis of annual (convergence) reports from the Commission. Nevertheless, in the first five months of the crisis following the collapse of Lehman Brothers, Central Europe was almost forgotten. Most banks of these 'outs' are owned by West European banks. The owners, themselves under huge pressures to recapitalize, were under great temptation to repatriate funds from their subsidiaries in new EU Member States to home. Upon an initiative of the EBRD in London, kept silent at first given the jittery financial markets at the time, these banks jointly committed to keep the funds in their subsidiaries, thereby preventing a much deeper slump in the Central European economies. Once this threat was realized, attention of the EU turned East and the EU (as well as the ECB) joined in with the IMF for adjustment assistance in cases such as Romania, Hungary and Latvia.

The actual or potential 'divide' between the Eurozone and the 'outs' remains an issue and it will not go away. The Eurozone is dominant with its 18 countries and its institutions; its resolve is by definition greater because it owns a 'collective good', the euro; and, what is often forgotten, each one of the currencies of the 'outs' have a mere satellite status vis a vis the euro.

3.2 Gaps and omissions of EMU revealed

The literature on EMU has always been characterized by controversies. Nevertheless, when the Eurozone celebrated its tenth anniversary, the official analysis (e.g. of the Commission) was relatively mild on shortcomings and gaps. Nowadays, there is consensus that the 'old' EMU was wrongly designed with respect to the links between market regulation, resolution and crisis management, on the one hand (e.g. prudential regulation, supervision, cooperation between national supervisors, resolution, contagion and systemic risks), and macro-economic policy, on the other hand, while its regime on national budgetary discipline appeared to be insufficient[10] . Moreover, it became clear that the constraints on the powers of the ECB had to be relaxed significantly. The ECB of 2014 can be said to have no less than ten tasks *more* than at the outset in 1999[11], some having been introduced under day-to-day pressure of the early crisis, other ones on a wider legal basis in the Lisbon TFEU treaty. In

home/host supervisors disappears for the Eurozone, it remains for non-participating EU countries (including colleges); (iii) the ECB works for the entire EU in its function of super-supervisor; (iv) the EBA will continue to develop the single market for banking; (v) the EBA Board of Supervisors has been reformed with the introduction of a double majority voting system (hence, a majority of non-euro area countries should be in favour, too); (vi) in the SSM (Single Supervisory Mechanism), a sort of non-discrimination clause has been inserted, in particular when non-euro countries participate in euro-denominated services. See European Commission, Economic Review of the Financial Regulation Agenda, SWD (2014) 1258 of 15 May 2014, pp. 267/8.

[10] However, it is crucial to note that a lack of budgetary discipline did not cause or significantly worsen the initial crisis (except in the case of Greece, which already had a high debt ratio and an expected deficit of no less than 6 % in 2009, when a new government found out that the deficit had been falsely underreported and, in fact, amounted to more than 12 %). Ireland and Spain enjoyed very low debt ratios and hardly deficits in the budget before the crisis hit.

[11] A careful survey by Darvas & Merler (2013) brings this out.

the first two years of the crisis, the ECB played a prominent role in providing liquidity in ingenious ways. Thus, already late 2008 banks could access any ECB liquidity they wanted (if collateral was sound) at a fixed rate; later, two extraordinary LTROs (Longer Term Refinancing Operations) were set up with maturities far longer than usual (up to 3 years) up to some € 1000 bn. Collateral requirements were temporarily relaxed as well. Nowadays, the liquidity function of (malfunctioning) interbank markets as well as security markets has also been facilitated by temporary ECB so-called 'outright monetary transactions' (OMT) for countries under special assistance for sovereign debt risks (Greece, Portugal until April 2014, Ireland until December 2013; Spain as it draws from the ESM for banks). The preparedness of the ECB (under funding conditionality) to make OMT *unlimited* has calmed markets and reduced risk premia for these countries, *without* actually activating a single euro under OMT contracts! Ironically, this highly effective and so far merely potential monetary power of the ECB – in fact, a pure lender-of-the-last-resort function which has only been announced, no more – has drawn fundamental criticism e.g. from the Karlsruhe Constitutional Court (having asked for a preliminary ruling from the CJEU on whether OMT is not illegal under EU law).

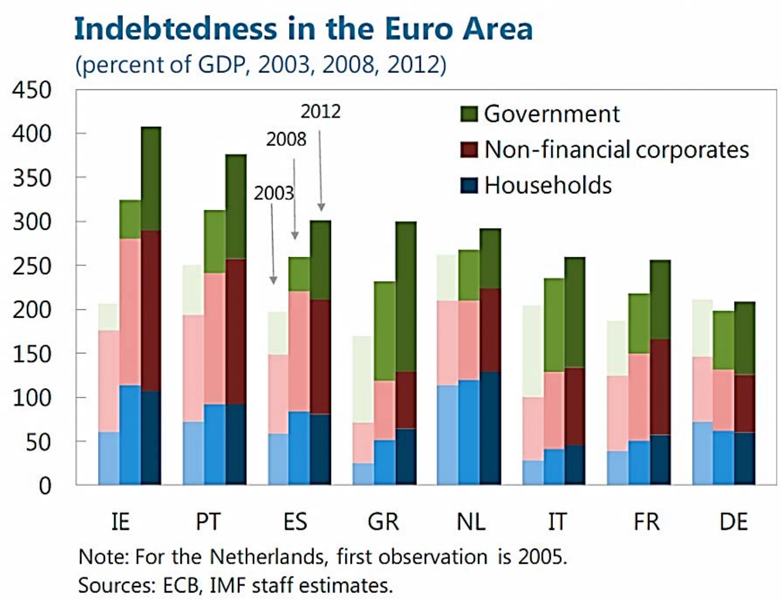
The 'old' EMU turned out to have a far weaker prudential and supervisory system than assumed, simply because the rules in the 2000-2006 period had become too 'light', the national supervision exceptions increased to some 150 and – something that, given secrecy, could not be observed – the supervisory committees did not function properly when needed most. Also, the lack of EU resolution power caused every EU country to become 'nationalist' as it were, since only national tax payers could provide 'fiscal capacity' (to give state aids or to nationalize). One should also consider this set-up against the European tradition that banks cannot go broke[12]. The idea that banks were basically privately owned companies that ought to bear risks and pay for insolvency, remained at best a secondary consideration. This presumption has two negative consequences: first, it implies major implicit subsidies[13] for greater risk taking (e.g. higher credit ratings than without the implicit government guarantee, hence, lower funding costs); second, it aggrandized the moral hazard problem of 'too big to fail', with dramatic consequences for the debt position of many EU countries once the financial crisis arrived. Hence sovereigns found themselves in the awkward position of having to rescue banks that, somehow, had not been supervised properly. With the 'light' prudential regimes, the 'own-capital' of banks had reduced to irresponsibly low ratios, sharpening the exposure to risks, yet, few if any authorities saw the onslaught coming.

But with massive rescue operations, in fact, private debt was transformed into public debt, without the toxic assets being taken out (say, into a 'bad' bank, although recently this did occur more frequently). Because the extra public debt was so large, and the toxic assets were so widespread, the Eurozone (and to some extent, the EU as a whole) got saddled with weakened banks *and* weakened sovereigns. Of course, this alarmed financial markets as well as credit rating agencies, after first having 'dosed away' for years. In other words, when risk taking should have been 'priced in', it was not. Once it was priced in – forced by rating agencies and jittery markets – it severely worsened the crisis both for banks and national

[12] Apart from the Herstatt bank in 1978 and BCCI in 1994, banks – other than very small ones - never went bankrupt in the EU, in sharp contrast to the US.
[13] In the range of € 59 - € 95 bn (or 0.5 % - 0.8 % of EU GDP). See European Commission (2014, op. cit.), p. 84

budget authorities. In turn, this created a 'doom loop' or deadly embrace[14], perpetuating the crisis by frantic deleveraging[15] and budgetary contraction, whilst financial markets remained extremely nervous with respect to risk premia. Surely, this deadly embrace had to be broken once and for all. In short, state funding had to be taken out of bankruptcy and resolution procedures as much as possible, shifting responsibilities and risks back to owners and managers.

Figure 1. Debt in the Eurozone : households, firms, states



Source : IMF (2013, p. 51)

At the same time, EU budgetary disciplines were tightened further (partly pushed by financial markets) which became pro-cyclical and hence worsened the problem for a few years. And this happened in an EU economy where *overall* indebtedness was very high in many countries (see Figure 1): whereas 2012 overall indebtedness is highest in the four MED countries and Ireland, private debts in e.g. the Netherlands are much higher than in any EU country, and e.g. French corporate debts (in % of GDP) are much higher than in e.g. Greece, Italy or Germany. As Figure 2 shows, apart from the 'deadly embrace', overall indebtedness (that is, for the state, firms and households) is in and by itself dragging down economic growth. These are typically the kind of observations that would have to be made by the ESRB, would it have existed before the crisis.

Yet, this was not all. Three additional problems had basically been ignored. One has already been touched upon: the vulnerability of banks in Central Europe (mostly, not part of the Eurozone). A perhaps even more serious gap in the 'old' EMU was the neglect of systemic risks, whether via permanent monitoring and surveillance of possible sources of later financial instability (such as bubbles), or, the assignment of the task to an EU institution.

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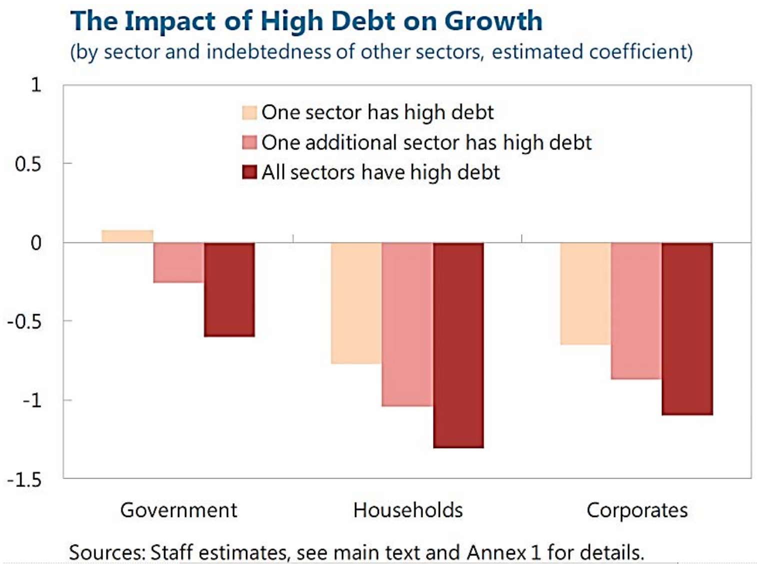
[14] De Grauwe (2011 ; 2013)

[15] In BIS (2013, p. 55), it is shown that, for continental banks, risk-weighted assets amounted to some 12 – 13 times Tier-1 capital in 2007 – 2008 ; with deleveraging, this fell to around 7 times, end of 2012.

Figure 2. (EU) Economy-wide indebtedness is bad for growth



Source : IMF (2013, p. 65)

The ESRB meanwhile fulfils this function, with the power of confidential or even public recommendations. The links between the ESRB and the ECB as well as with the European supervisors should ensure that authorities remain on guard and consider timely corrections or constraints for the demand and supply side. Third, the structural imbalances on the current accounts of the MED-4 countries, long financed by financial players in other countries of the Eurozone, were largely caused by a shift from the tradable to non-tradable sectors (such as construction, growing into bubbles) as well as by excessive wage increases far above productivity growth. As the latter are unsustainable, corrections are bound to happen. Nonetheless, as long as such wage increases take place especially in booming sectors (despite low productivity growth) due to bubbles, the correction will be postponed, perhaps too long. Once, for domestic or external reasons, a re-assessment of investments or financing is undertaken, there is a serious risk of 'sudden stops' of funding, in turn prompting an immediate and severe crisis.

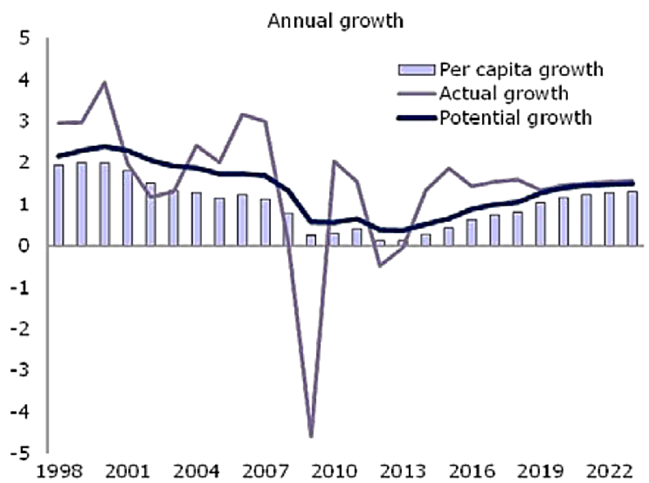
In yet other cases (e.g. the Netherlands, a long time fine performer in the EMU), private financing of housing was pushed to extremely high ratios of 120% or even 130 % or 140% of the market value of the house in good times despite, or indeed precisely because of, secularly rising house prices in the 1990s and the 2000s. With the crisis lingering, house prices started to fall with a lag (a logical market reaction) causing some 1.3 million households to witness their property values sharply going down (a negative 'wealth' effect) while being stuck with very high monthly financing requirements. This wealth effect deepened the crisis in the country as savings were given priority and demand from many consumers fell drastically. In turn, this led to the highest current account surplus of the Eurozone (in %) for several years now. Exactly when sustained demand from stronger euro countries should at least have helped the adjustment of MED countries somewhat via exports of goods and/or tourism and other services, this imbalance had the opposite result.

3.3 The EU lost its growth mission

Traditionally, the EU growth mission was connected to the deepening and widening of its internal market, with the help of the relevant common policies to make the market 'function properly'[16]. Much later, this was complemented by wider EU strategies (e.g. the Lisbon process between 2000 and 2010; the EU2020 programme) under which EU Member States would cooperate in areas of national competences, expected to enhanced productivity growth in Europe. With the Eurozone becoming operational, a long-term structural reforms agenda for euro countries (but also for all EU countries, yet with a lesser urgency) to improve the adjustment capacity of the currency area and stimulate convergence was pursued as well, be it with modest and partial results until the crisis.

After five years of crisis, the EU seemed to have lost its 'growth mission'. The internal market was steadily being deepened[17] but in a slow and inconspicuous manner, yielding relatively small economic gains. Only with the Monti report[18], a new ambition was generated. But the classical single market approach - sound in and by itself – had long become far too narrow. The crisis clarified in a painful way that suboptimal economic design, problematic quality of some EU rules (e.g. for financial markets) and of some weak institutions could severely impair trend growth. Moreover, severe constraints caused by the rigid two-tier structure of EU governance were capable of wiping out many years of accomplished economic growth. The basic flaw in EU economic governance refers to the existing division of economic powers between the national and EU levels which is no longer based on what a functional subsidiarity test would suggest for the better functioning of the EU economy at large and the Eurozone in particular. Worse still, the recovery is likely to be slow and the expected trend growth until (say) 2020 is bound to be below the already modest trend growth before the crisis (see Figure 3). There is simply no point in promoting soft EU2020 strategies (in an 'innovation union'.

Figure 3. Worrisome economic trend growth of the EU



Source : European Commission (2013b)

[16] See Pelkmans (2006), chapters 2 and 3 in particular.
[17] A survey of single market deepening between 1993 and 2010 is provided in Pelkmans (2011).
[18] Monti (2010), followed by the 2 Single Market Acts of 2011 and 2012 respectively.

or a 'new' industrial policy, etc.) and piecemeal internal market improvements, without first addressing these more fundamental questions of EU economic integration.

The slogan 'never waste a serious crisis' is a pertinent ambition for the EU. It is crucial not to consider the 'genuine EMU' debate as a mere technical debate about a better Eurozone. Not only is a lousy Eurozone also bad for the EU as a whole, but many of the issues which have to come to the fore in the Eurozone are often just as relevant (but perhaps slightly less pressing) in the EU-28. This is true, in particular, about the insufficient 'reach' or intrusiveness of the internal market in the economies of the Member States. The implementation of the 2006 horizontal services directive has clarified this in a stark manner[19]. After enacting this important directive, Member States jointly seized 'ownership' of the deep implementation track over a period of four years, assessing no less than 35000 legal services provisions in national laws and decrees, removing numerous restrictive or discriminatory clauses and introducing around 1000 new laws or other secondary acts. Nevertheless, after this mega-effort, there are still doubts whether the directive is sufficiently intrusive inside Member States in all submarkets. Another telling illustration is found in the regular troika reports of notably Greece and to a lesser extent Portugal about their domestic reforms: amazingly, several reforms in these programmes revealed that the reach of the single market in some sectors simply had not been sufficient to introduce or stimulate effective competition and inter-sectoral adjustment, a necessary condition for growth and competitiveness. Detailed assessments of Italian reforms, even after the short-lived Monti government, strongly suggest similar problems of a selective delinking of the single market and national economies.

Today's two-tier structure of EU economic governance is not only inappropriate for the EU economy, it hides 'systemic risks' of structural underperformance which ought to be addressed. Selective instances of centralisation – mostly in the Eurozone, but in e.g. banking, for all EU-28 countries – should be coupled with well-chosen mechanisms to circumscribe national regulatory and policy discretion where the economic case for structural reforms is widely accepted by (say) the Commission, the OECD and the IMF. It is not suggested to 'impose' such limitations. Yet, it should be imperative for Member States not to read the broad economic policy coordination articles [20] with a legal mind set of how to minimize their practical impact in domestic politics, but, instead, be regarded as part of a joint economic evaluation of what the Union requires for growth. In this respect, the European Semester is a step forward, as it is 'Europeanising' national parliamentary economic policy debates and doing this simultaneously in all EU countries, without suggesting more centralisation.

[19] In Mustilli & Pelkmans (2013) this point is elaborated in great technical detail

[20] Art. 120 and 121 of the TFEU. The first one comprises an obligation of Member States : "…shall conduct their economic policies with a view of contributing to the achievement of the objectives of the Union…. and in the context of the broad guidelines..". Art. 121, TFEU ensures that national economic policies are not 'stand-alone' ones : "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council..".

4. Fiscal union, more or less in place ?

The term 'fiscal union' may mean different things to different people. Whereas the case for central EU supervision of banks and their eventual resolution is strong and convincing, the logic of establishing a fiscal 'union' is less straightforward and also depends on one's ambition about EU integration *beyond* the proper functioning of the monetary union. The basic argument in favour of having a 'fiscal union' hinges on answering how to serve best the proper functioning of the monetary union and the (internal) banking market as a delicate aspect of it. The fiscal union in this sense belongs to the 'Eurozone' but might nonetheless be voluntarily adhered to by some of the 'outs'.

However, some economists and a few leading politicians (e.g. former Belgian Prime Minister, now MEP, Guy Verhofstadt) widen the role of a fiscal union to broader macro-economic stability policies. This additional role has a long history in EU debates going back all the way to the 1977 Macdougall report advocating an EU budget of 5% or more of EU GDP in order to pursue EU-wide macro-economic stabilisation policies.

More modest versions of an EU common employment insurance fund and/or a limited form of expenditure insurance can also be found[21]. However, this additional role of a fiscal union implicitly suggests that the Eurozone (or even the EU at large) should mimic a federal state EU-style or even the US to some extent, in that macro-economic stabilisation between countries (or states) is best assigned to a central budget. Or at least to some extent. In other words, the 'old' EMU with central monetary functions is held to be imbalanced as fiscal policy should be centralized to some non-trivial degree as well.

This argument is more political than economic. Politically, it hinges either on a preference of 'more Europe' in general, or, on a serious concern about a lack of support of EMU among EU voters following the crisis and its negative fall-out. Therefore, many economists and others advocate some such additional EU fiscal role and connect it with what is labelled 'political union'. The political union would somehow have to generate political legitimacy and support in the electorates for EMU and its good and sour consequences. This is briefly dealt with in section 6.4.

Economically, this debate goes back to the EMU debate of two decades ago[22]. The relatively large *national* budgets in the EU have considerable stabilisation capabilities, both via discretionary spending and via the so-called 'automatic stabilizers' (automatic, because in a recession, tax revenues decline and social payments increase). Given the large share of GDP of national budgets (unlike states in the US), this can be quite effective in smoothing demand over the cycle.

If all EU countries do this during an EU-wide recession (and automatic stabilizers guarantee that in part), the EU economy will benefit, too. For this national stabilisation function to work well, national budget discipline (under SGP and the new six and two-pack rules) should

[21] A recent note by IMF Staff (Allard et al, 2013) advocates some fiscal risk sharing via an insurance mechanism - hence, temporary transfers - based on purely economic arguments, but even these authors admit the 'political costs from ceding some national sovereignty over budgets'.

[22] See Gros & Thygesen (1992) for a survey.

guarantee that enough spending room has remained available *before* the downturn arrives; moreover, there should be no nasty surprises such as the rescue of one or more banks (which assumes tougher prudential rules, supervision and unbiased resolution power) which would undermine sound budget policies. Hence, for a 'genuine EMU' implying budget discipline and few, if any bank failures asking for rescue, the additional stabilisation functions of a fiscal union are *not* compelling[23].

This is quite apart from the question of political feasibility of such a more ambitious fiscal union, which is zero at the moment. It is not hard to see why: Member States have been extremely sensitive about the EU budget (kept it at 1 % of EU GDP for decades now) and have consistently refused to endow the Union with even limited tax powers. Earlier proposals for a kind of macro-insurance mechanism have not even been put on the Council agenda. One should also realize that the political nature of the Union would change once tax powers are given to the EU. In a climate of rising euro-scepticism, pushing such ideas might even backfire.

The 'fiscal union' helping the monetary union to function properly has three components:

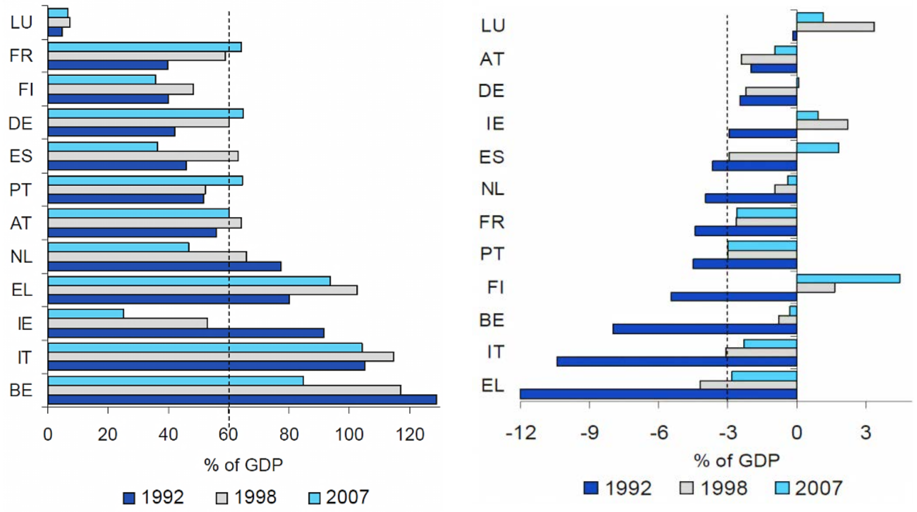
(a) *disciplining* Eurozone (or EU-28) *national budgets* according to treaty provisions, the SGP, and its tightening via the six-pack and two pack rules. Essentially, this implies zero budget deficits over the medium term and a debt ratio of 60 % or decreasing to that level in an unambiguous fashion. The main economic reasons include the minimisation of (negative) fiscal cross-border spill-overs and the pre-emption of any political pressure on the ECB to loosen monetary policy for purposes of easier nominal debt relief (via inflation). In terms of debt in the longer run, it is about fiscal sustainability given ageing and health costs.

(b) the establishment at EU or Eurozone level of strictly limited and conditional *common funds for crisis management*, be it for sovereigns with high debt ratios when financial markets are unwilling to buy bonds except with very high risk premia (which could generate vicious circles), be it for bank resolution and bridge finance as a necessary complement of EU level supervision. Note that the latter might be partly or wholly financed by the banks themselves (building up over time) and/or via an EU-wide deposit insurance system.

(c*) fiscal guarantees* (or, backstop) of a common resolution authority's decision to intervene, if and insofar as privately financed common funds for crisis management might not suffice. Such guarantees are likely to come from Member States. Except for the beginning of bank resolution at EU level, when such funds still have to be built up, these guarantees might actually never be used.

[23] Daniel Gros (2013f) has added an additional economic argument causing one to be highly cautious when macro-economic stabilisation powers are advocated to be shifted (to some degree) to the EU level, in analogy with the US. Gros shows empirically that the federal macro-stabilisation effects in the US are actually quite modest, certainly compared with the impressive stabilisation effects of the US 'banking union' in the event of a financial crisis.

Figure 4. Eurozone budgetary discipline before the crisis



Source : European Commission (2008); left hand side, state debt / GDP ratios in % ; right hand side, deficits

Since the latter two components are of direct relevance to ‘weak’ banks and the first might be negatively affected by weak banks, the banking union and the fiscal union are twins. With the banking union (see section 5), the EU level was in need of its own ‘fiscal capacity’.

The first component, national budgetary discipline, has been a prominent issue ever since the Maastricht treaty, incorporating the famous 3 % (for ‘excessive’ deficits) and 60% (debt ratio) thresholds for *entry* into the Eurozone. With the Stability & Growth Pact (SGP), this was made applicable also after adopting the euro, that is, to existing members of the club, with the option of sanctions under Council control. This left something to be desired as the threat of sanctions was perhaps realistic for small countries like Portugal and Ireland, yet was blocked for Germany and France in 2005. For this and other reasons, the credibility of SGP was often called into doubt. Debt ratios of countries like Italy and Greece went down only excruciatingly slowly and Portugal turned out to be permanently in excessive deficit procedures, for example.

Nevertheless, one ought to concede (see Figure 4) that the overall budget disciplines of Eurozone countries in 2007 was better than during the 1990s and even when the Eurozone started[24]. The weaknesses have been addressed in four of the directives/ regulations of the Six Pack of November 2011 and in the Two Pack of May 2013[25]. The EcFin Commissioner (now Ollie Rehn) has been assigned special authority and duties of ex ante surveillance in the framework of the so-called European Semester. The latter aligns timing and relevant substance of national budget procedures, in a tightly coordinated fashion led by the Commissioner, seeking to ensure that national parliaments (when approving national budgets for the following year) duly consider and incorporate the disciplines and recommendations about fiscal sustainability agreed at EU level. This coordinated set-up in a joint calendar for all Member States generates political costs for neglecting the EU. In order to add credibility, 25 of (then) 27 EU countries signed an intergovernmental ‘Fiscal Compact’

[24] See European Commisson (2008).
[25] For a careful survey of this strengthened fiscal framework, see European Commission (2013a).

in March 2012[26]. At the time, the Compact was seen as a necessary boost for the tedious political process of toughening ex ante surveillance. Indeed, by committing themselves firmly, Member States succeeded in concluding the Two Pack (overlapping with the Compact, for example making possible reverse qualified majority voting on all the steps of the excessive deficit procedure) with strong support of the EP. One accomplishment of the Compact is that (25) Member States must enact a *national* law imposing certain budget disciplines, thereby averting cheap accusations of a 'Brussels diktat'.

The second component of the fiscal union is the funding of a Eurozone crisis mechanism for sovereigns with high and/or rapidly rising debt (due to bank rescues) and extreme risk premia in the interest rates they have to accept to pay when selling their bonds in capital markets. After a short-lived emergency fund, the permanent mechanism is the ESM, the European Stability Mechanism with some € 500 billion available. Today, it pays the emergency funding for Greece and Portugal, and until December 2013, Ireland. This is only done, however, once the troika of the European Commission, the IMF and the ECB reports favourably (regularly) about the implementation of strict adjustment and reform programmes, and the Euro Group subsequently agrees and approves.

The strict conditionality of the ESM has a deterrent effect on other possible 'candidates' such as Italy (high debt ratio and a low capacity to reform) and Spain (depression-like unemployment and negative growth until 2014, plus some bank rescues, causing huge pressures on its budget). These countries have taken many measures in order to prevent having to ask for ESM funding. Of course, these initiatives go in the same direction but maintain a degree of discretion for domestic socio-political acceptance. For a while, it was (and possibly still is) unclear whether these two relatively big economies can return to growth quickly enough and gradually improve their situation such that risk premia will start to fall based on improved economic fundamentals. Once Spain or Italy would have to request ESM funding, fears might grow that the ESM is too small, and financial markets might become jittery again. It is for this reason that the OMT offer of the ECB is so important, as it has successfully calmed down the markets[27]. Spain did succeed in obtaining ESM funding for supporting Bankia (a near-failed merger of local savings banks), even though ESM funds are meant for sovereigns, not for (preventing) resolution of banks. However, the connection between the Spanish budgetary predicament and the Bankia rescue is so close that this exception was allowed, in anticipation of the arrival of EU resolution powers.

The funding and fiscal back-up of EU bank resolution power is no longer taboo. But the philosophy has drastically changed. As the treaty forbids 'bail outs', the ESM had to be drafted in ingenious ways and rigorous conditionality was a logical implication. A new EU-level arrangement for resolution stimulated a course of action that was first tried in the Cyprus banking crisis: called *'bail-in'*. It shifts responsibility for irresponsible risk-taking back

[26] The treaty on Stability, Coordination and Governance of 2 March 2012

[27] De Grauwe & Ji (2014) show econometrically that, so far, the sharp decline in risk premia (hence, interest rates) for MED-4 counties since mid-2012 is not due to economic fundamentals improving, but solely to OMT.

to managers and owners of banks, and even large depositors (above € 100 000)[28]. When these means are exhausted, national fiscal 'back-up' comes in (under strict and new state aid rules) and only when this would still not suffice, complementary funding from the ESM is possible, if the bank can be made viable.

The EU resolution regime consists of two pieces: a Single Resolution Mechanism and the Bank Recovery and Resolution directive (see also section 5). The critical point for the fiscal union is that 'bail-in' has now become an agreed principle, in other words, moral hazard is pre-empted and private equity, large depositors and managers' destiny will presumably be incentivized to avoid failure. National state aid and subsequently, EU funds may come in, if and only if a merger or acquisition or restructuring enables the bank to remain viable, be it with some funding. However, the extensive resolution powers may further minimize or pre-empt any public funding by e.g. establishing a 'bad' bank or via other arrangements. On the same logic, the EU funds for resolution will consist of bank-funded resources - built up over a period of 10 years to € 55 billion. Only the fiscal back-up consists of public money from taxpayers.

As will be discussed in section 5, it is precisely in the early period of EU resolution – when funds are still small and the new EU supervisory regime will make itself felt – that public money might still be unavoidable. This would be due to the legacy of still too weakly capitalised banks. With the strict assessment by the ECB of the hidden risks in the 128 largest banks in the EU, under way during 2014, it is possible that the so defined 'capital needs' of a number of these banks is outstripping the capacities of such banks to attract extra capital (or e.g. merge), so that the painful resolution choice might be between controlled unwinding of some banks and renewed public capital funding (which would bring back the deadly embrace, if the latter is too big). We shall return to this tricky problem in section 5.

Finally, it might be useful to clarify what fiscal union is *not*. As noted, it is *not* about an EU budget – or, as some suggest, a Eurozone budget – with stabilisation functions. There is, however, a possible though minor link between a 'genuine EMU' and the EU budget: as domestic reforms, especially during a crisis, can be painful to the point of becoming unacceptable by voters, EU funding for a growth or investment agenda besides austerity measures may be a useful way to help the country with a quick turn-around back to growth. The fiscal union of the 'genuine' EMU is surely *not* about (EU) taxation and new 'own resources' for the Union, although one can make a good case for a much larger share of 'own resources' in the total receipts of the EU. This case has been made many times

[28] More precisely, if a bank needs to resort to bail-in, authorities would first write down all shareholders and would then follow a pre-determined order in bailing in other liabilities. Shareholders and other holders of instruments such as convertible bonds and junior bonds would bear losses first. This is a citation from Commission Memo 14/294 of 15 April 2014 (as the text of the Single Resolution Mechanism and of the BRRD (the Bank and Recovery Resolution directive, for all EU; the difference is essentially that the national resolution funds are pooled into a single Fund in the case of euro countries) have not yet been published in the EU Official Journal by 1st of June 2014 (when this paper was finalised). The EP formally adopted the BRRD and the SRM on 15 April 2014. Besides, it also adopted a harmonisation directive on national deposit insurance regimes.

before [29] but national governments choose simply not to listen to such functional arguments – for them, the EU budget is politicized (unfortunately, mainly by them, fearful of euro-sceptical voters). Their 'contributions' are framed as a burden for the national taxpayer, to be minimized, *not* as a normal expenditure in the EU public interest. Nevertheless, there is talk about Union bonds[30], a kind of joint funding for national projects. *Neither* is fiscal union about big sums of (EU) money: it is mainly about budget discipline of the Member States, including longer-run fiscal sustainability, only residually about joint guarantees of the Eurozone countries and even less about the EU budget. Its overriding purpose is to ensure that the monetary union and the underlying single financial services market can function properly.

5. Banking union: why and what it takes?

The EU banking union is a catchy name for answering the following question: what positive integration is required to make the internal market for banking services function properly. This includes the appropriate governance for pre-empting and managing systemic risks such as cross-border contagion or unwanted fiscal effects (as discussed in section 4). Banking union as an issue is therefore nothing new (other than the name). What is new is the changed mind set of governments, now willing to 'go European', although some more than others. The new mind set has two concrete consequences: (a) existing EU rules and coordination of banking supervision can be drastically improved, including EU-level institutions with a degree of centralisation; (b) EU supervision can be made credible by complementing it with EU bank resolution powers and the funding for it.

Before elaborating on the banking union, it is important to realize that it is built to facilitate and enhance the functioning of the internal market for financial services, especially but not only banking[31]. This ambition can lead to justified forms of centralisation that might not have been envisaged initially. Indeed, the ultimate consequences of the 'proper functioning of the internal market for financial services', encompass a complete and effective bank resolution regime, with adequate funding. In turn, this should break the 'doom loop' as huge extra public debt will no longer be forced upon the state when a bigger bank is failing.

This sensitive centralisation has prompted many headlines and discussions, understandably. In the heat of these debates, the main reason for the selective centralisation remained out of sight: a sound financial market in the EU for growth and competitiveness. Sadly, financial market integration in the EU leaves much to be desired. First, even before the crisis, there were sub-markets which remained fragmented, such as mortgages, some other forms of consumer credit and retail banking services in the general sense; fragmentation also lingered due to 'home bias' in portfolio allocations in the EU and a strong domestic preference for

[29] See for instance surveys in Begg (2009) and Begg (2011).

[30] Not to be confused with Euro bonds, which mutualize all national (past) debt as well

[31] In other words, accomplish the appropriate 'positive integration' in order to enhance the 'negative market integration' of free movement and the right of establishment in financial markets in the EU, as a source of higher economic welfare and, indirectly, by stimulating growth via deep, efficient and vibrant financial markets. The deeper such market integration, the stronger the case for a banking union.

bank mergers. Despite these integration deficits, financial market integration at first increased after the euro was introduced[32]. This is critical for improving monetary transmission in the Eurozone but it is also likely to lead to efficiency gains. Second, as noted before, during the crisis, financial market integration receded and fragmentation in several submarkets worsened (although this process stopped after OMT was announced – June 2012 – and partially reversed [33] once plans for banking union turned out to be credible).

The EU banking union comprises four elements:

a. a single (prudential) rulebook for banks, and in its wake, an EU single supervisory handbook for national supervisors;

b. pan-EU (and EEA) banking supervision, led by the ECB and the EBA;

c. an EU-wide bank resolution regime (rules, an EU fund and a resolution authority);

d. an EU-wide deposit guarantee scheme, preceded by the harmonisation of national deposit guarantee schemes.

In the spring of 2014, the status is as follows : (a) is under way (and much progress has been made[34]) ; (b) has been enacted[35], but the centralised ECB part is coming into force only by early 2015, with the run-up to this initiation during 2014 characterized by a tough preparation required by the ECB; (c) has been enacted by the EP on 15 April 2014 as a package both for all EU countries (the BRRD) and for Eurozone countries (SRM)[36]; (d) the EU-wide deposit guarantee scheme has been put on the backburner (e.g. Germany is reticent), but a harmonisation of national schemes has been enacted on 15 April as well.

This fourfold package is an amazing achievement in the light of the outright refusal to take such forms of functional centralisation serious until the crisis [37]. Yet, given the design failures of EMU combined with the ‘deadly embrace’ and its now well-understood drastic consequences, many economists wonder whether this package is fool-proof. The short answer is that in the short to medium run, the package is rather vulnerable due to a significant sequencing problem to be discussed below. In the longer run, it is likely to be fairly robust, if the initial experience with the system would not cause too much damage to its credibility. It would be even more robust if the EU resolution fund would be part and parcel of a sound EU-wide deposit guarantee system.

[32] ECB (2008)

[33] In ECB (2014) this partial reversal is empirically shown for several financial submarkets. Also, the European interbank market – collapsed in the beginning of the financial crisis – is close to operating at the pre-crisis level.

[34] The present contribution cannot possibly go into the numerous details of this huge programme. A concise, yet rich summary is provided by the European Commission in Memo/14/352 of 15 May 2014 and its Annex. See also COM(2014) 279 of 15 May 2014 and the Commission’s SWD of the same date, quoted before.

[35] See Council Reg. n 1024/2013 of 15 Oct 2013, conferring specific tasks to the ECB, OJEU L 287/63 of 29 Oct 2013, and, Reg. 1022/2013 of 22 Oct 2013 amending Reg. 1093/2010 establishing a European Supervisory Authority (etc.) OJEU L 287/5 of 29 Oct 2013.

[36] Not yet published in the EUOJ. See footnote 28.

[37] Even the 2009 De Larosiere report on the EU banking crisis, tough in its analysis of the weaknesses of supervision and the far-from-single rulebook, was hesitant still in this respect. See also Lannoo (2009).

The crux in the short run is the gradual assumption by the ECB of its supervision of the 128 large banks by preparatory scrutiny in the course of 2014. The ECB is bound to secure its high reputation by being a tough and prudent supervisor. This toughness does not only arise from the requirements it will impose (see below) but also from the mere fact that it is a credible EU-wide rather than a national body, not suffering from inter-governmentalism (as the EBA still does). The latter two points are the very reasons why centralisation of supervision, certainly for big and networked banks, is functional and should be expected to be good for EU economic welfare. When searching for optimal economic design of EMU, this element is crucial, no doubt. But there might be a possible snag. The ECB will work, indeed will have to work[38], closely with national supervisors. Dependent on how fragile some of the banks might be found to be and how large capital shortages might be, given yet undiscovered risks and/or the still too low capital requirements, the ECB might find itself in the difficult position of having to be tough on the remedies without yet being in the position of triggering the Eurozone resolution fund, as it still has to be built up. This is akin to ‘supervision without the ultimate fiscal capacity for resolution’, which boils down to a renewed inter-governmentalism through the backdoor, at least initially, as only the Member States will initially have fiscal capacity.

What are these preliminary requirements in the run-up to fully-fledged ECB supervision?[39] With the fragile state of (some) European banks, three prior checks will be conducted:

i. an asset quality review, which has already started ; run by national supervisors under ECB guidance and direction; seeks to identify where and how much, overvaluation (in the books) of assets’ market value of banks exists;

ii. balance sheet assessment for the 128 banks, based in part on i;

iii. new EBA stress tests, tougher than both the 2011 and 2012 ones.

The idea is that banks which are severely undercapitalised will either (a) default as not viable without help (and bank resolution comes in), or (b) require public funding (but precisely that ought to be prevented or minimized as this recreates or magnifies the ‘doom loop’), or (c) have to merge with a sound bank, also cross-border, or (d) obtain new capital from capital markets as – given the new tough supervision – banks will be forced to have a sound business model. If any public funding for survival under the new supervision would still be inevitable, the questions are whether the fiscal backstop via state aids (disciplined by tough state aid rules) would suffice, and whether the ESM would come, and to what extent.

[38] Besides the experience and knowledge of national banks, which national authorities have, other reasons include that bankruptcy laws are national (and different) and not all Member States dispose, as yet, of the clear authority to impose bail-in as required by the BRRD. This will take some time for implementation. Anyway, the sheer amount of work of the full assessment, with its incredible details, demands decentralised, yet tightly coordinated, execution of the reviews of banks.

[39] The following is based on the most recent debate on this subject and hence still somewhat preliminary. See e.g. Veron (2013a ; 2013b; 2014), Leipold (2013), Micossi, Bruzzone & Carmassi (2013), Gandrud & Hallerberg (2013a ; 2013b) ; Merler & Wolff (2013) ; Gros (2013a ; 2013b ; 2013c; 2013d) ; Emerson & Giovannini (2013), Kool (2014)

The 128 big banks are thought to cover around 85% of all bank assets in the EU (which means that nearly 6000 other ones, supervised by the EBA, with the ECB in the background but with residual powers, control only some 15 %). The ECB role is mainly justified because the large banks ('too big to fail') might represent systemic risks and hence cause financial instability. Therefore, the ECB is split into a supervisory part and a monetary part; the former will only take over some tasks from the EBA and the national supervisors in it.

The new supervisory regime cannot be effective without resolution powers and funding for that. The present paper cannot go into more than the basics of the emerging EU resolution regime, as it has been agreed. There were two proposals: (a) the Single Resolution Mechanism (SRM); (b) the Bank Recovery and Resolution Directive (BRRD)[40].

The SRM has a two-tier structure: at *EU level* there is a Single Resolution Board (which can, if necessary, directly intervene if national foot dragging takes place), the Commission (deciding when and how resolution will take place; note that the Commission is a member of the Board as well) and the Single Resolution Fund, funded by banks over a ten years period and expected to end with € 55 billion.

At *national* level, the resolution authorities will have to execute the resolution plan. As noted, the core principle of EU resolution is 'bail-in', with back-up by national authorities. Gradually, the SRF would be able to take over. Of course, it is important to keep in mind what resolution funds – also the SRF – ought to do and not to do. The SRF is not meant to serve as a remedy for the chronic undercapitalisation of (many) European banks. So, if a bank goes into resolution, the SRF should merely provide bridge money – it is neither there to compensate shareholders nor to recapitalise the bank fully[41]. It should merely support a restructuring or a split between a bad and a sound bank or bridge a short period before a complex merger (a rescue merger). For such purposes, the money needed is likely to be modest and could be returned fairly quickly too.

Nevertheless, fears exist in the EU that there is a time inconsistency problem. The triple preparatory test imposed by the ECB& EBA takes place during the first half of 2014 or perhaps into the autumn. Expectations are that the ECB will uncover a number of non-viable banks or at least banks that would require resolution measures of some kind, typically cases where national supervisors avoid or postpone such action[42]. In a revealing analysis, Acharya & Steffen (2014) show empirically that, for a sample of 109 of the 128 banks, the capital needs (without stress tests) would amount somewhere between € 7.5 bn and € 66.8 bn,

[40] For the proposals, see COM (2013) 520 of 10) July 2013 establishing uniform rules and a uniform procedure for the resolution of credit institutions (etc.) and COM (2012) 280 of 6 June 2012 on bank recovery and resolution (etc.), both enacted on 15 April 2014 in adapted form.

[41] It is not desirable but – as Gros (2013d) points out – it is also out of the question if several bigger banks would go into resolution, with public money. The banking system in Europe under the SSM has total assets of nearly € 25 000 billion, whereas their capital amounts to some € 1000 (hence, 4%). The ECB might impose 6% eventually.

[42] Incidentally, that is one reason why some observers advocate that national resolution bodies be independent under statute, preferably based on EU rules.

based on a capital ratio of 8%[43]. If the ECB will stick to 6%, it is unlikely that much of this would be needed or it can easily be solved. However, the picture drastically changes once stress tests are employed. In four stress tests, capitalisation needs would vary anywhere between € 82 bn and € 767 bn (the latter with a required 7% capital ratio, which is rather prudent). The authors also emphasise that prevailing risk weighting of assets would have to be reviewed first, as these weight my result in too rosy results in some cases.

If this analysis would be even approximately correct, a problematic situation would arise: late 2014 there will not yet be a single resolution regime yet in place or in force, hence no Single Resolution Fund. One awkward scenario is a tough central supervisor (the ECB) finding itself dependent on national resolution authorities to act. This dependency will only be short-lived, until the resolution regime/ fund will come into force.

Nevertheless, precisely in this short period it might undermine credibility and/or lead to open frictions about what banks have to die or be restructured. This might also shift the issue to the EU competition authority (the Commission's DG Competition) having published state-aid guidelines on 'bail-in' in August 2013. Yet, all this is exactly what was to be prevented – resolution by supervisors and specialized resolution bodies is much to be preferred to state-aids and faster, too.

Also, the pressure on the ESM might intolerably increase, dependent on how many 'skeletons' or 'zombie banks' the ECB might uncover. This prospect might, in turn, lead the ECB to be a little less tough which might damage its reputation from the outset. It is hard to say how realistic such scenarios would be. Every year the European banks disparately attempt to strengthen their core capital and one additional year might help somewhat. But this implies that banks withhold credit, thereby throttling the EU exit from the crisis and creating a Japan-like very-low-growth economy for years. The core issue should be whether there might be a systemic question or not. In case EU financial stability is not endangered and the issue at stake is the resolution of an individual bank, or even several ones, one can credibly argue that public money should not come in. Bail-in and such restructuring that capital markets are again willing to help recapitalise or to organize a merger/takeover, should be sufficient and EU resolution money should merely serve as bridge finance. With bigger banks, some public money might eventually be required but this should be conditional upon restructuring and returning to a sound business model.

The resolution regime as now foreseen has two defining features: supranationalism (Board is powerful, can directly intervene, and votes with simple majority, no vetoes) and market-based (bail-in and in principle, no aids). Such a regime will decisively undo the 'deadly embrace'. But the supranationalism is less firm than one would wish to see[44]. The benefits

[43] The authors use 4.5 of core Tier 1 ratio, plus a capital conservation buffer of another 2.5% plus a 1% surcharge for systemically relevant banks.

[44] Kool (2014) points out that any substantial call on the resolution fund will require a decision from the plenary of its Board (i.e. all relevant Member States); the European Council and the Commission may trigger a special blockage of the Board's decision in exceptional cases. However, it should be noted that the text is written for weekend decision making. Not only would a SRB decision have overruled the Commission, as a member of the Board, the Council gets only 24 hours to respond; even then, the SRB is expected to modify its decision, which might still mean that resolution would proceed in an adapted version.

are three. First, finally the EU can deliver quick and effective decision-making in crises, with much more limited funds than needed under the great uncertainty in Europe in the period 2008 – 2012. Second, from now on, a central body can build up expertise from cases in the vast EU market, rather than the rare domestic instances, and this functionally without capture. Third, the regime protects tax payers and creates a level playing field in all participating countries. It is unclear whether and when an EU-wide deposit insurance guarantee system would be established that would underpin the ESM and the resolution fund. Once harmonisation is in force (expected by the spring of 2014), however, bank runs are discouraged even more and the national systems can extend loans to one another.

6. What serious issues need no 'unions'?

Having dealt with the fiscal and the banking union (and taking the monetary union, in this paper, for granted), this leaves four other 'unions': economic union, the 'competitiveness' union, the political union and a social union. I shall be relatively short on those.

6.1 *Economic union*

The economic union is a vague term with many distinct interpretations since the late 1940s[45]. It became (more) connected to monetary union since the Werner report and, ever since, the term EMU is used routinely in Europe and beyond, without giving the 'E' of it too much thought. Yet, in the Werner report the 'economic union' cannot be taken serious. It can easily be shown that, if the monetary union proposed by Werner would have been based on the economic union from that report, it would have led to disaster[46].

The Maastricht treaty has formally introduced EMU, without however defining 'economic union'. The relevant text in the current TFEU has remained unchanged. Initially, the de facto interpretation of economic union was heavily biased towards 'budgetary' aspects, say, the deficit and debt rules for entry and the SGP. Of course, this cannot be appropriate for the simple reason that economic union must, in any event, comprise the single market as a whole, without which a monetary union would make little sense.

However, the budgetary discipline in the treaty is dealt with together with monetary union. Understandably, because the two principal reasons for budgetary discipline (as noted under 'fiscal union', above) show that such discipline is to serve the proper functioning of the monetary union. Nowhere in the treaty is there a reference to the single market and possibly complementary features as central elements of the economic union[47]. Yet, a deep single market with a wide scope integrates the economy of the EU, including the Eurozone, and hence serves as the foundation of monetary union.

The E of EMU is also likely to comprise 'economic policy coordination', similarly for the better functioning of the monetary union, and, in a weaker form, even without it. This is the only element where the treaty explicitly refers to the link: in Art. 121/4, TFEU, when

[45] See Pelkmans (1991) for a survey.
[46] In Pelkmans (2006), in Case Study 18.1, p. 383, this is explained in detail.
[47] With some interpretation, one might read that in Art. 119, TFEU.

Member States' economic policies are not consistent with the broad guidelines, they may ".. risk jeopardising the proper functioning of the economic and monetary union". The economic coordination apparatus of the EU has become much more ambitious during the crisis, in particular with the European semester, in turn based on the Annual Growth Survey of December, and the tighter interactions on all kinds of recommendations for Member States, including domestic reforms in many policy domains and country-specific calls to better support the deepening of the single market.

Therefore, despite the lack of a strict definition of the E of EMU, the economic union is taken more serious today. If, for simplicity, we say that it comprises at least three important elements (single market, budgetary discipline, economic policy coordination), the conclusion is that all three have developed and become far more important than at the time of drafting the Maastricht treaty. Nonetheless, the reader should never forget that, more often than not, the three elements are dealt with separately and the semantics of 'economic union' are forgotten.

6.2 *The Competitiveness union*

The 'competitiveness union' is a misnomer. There are essentially two critical problems of 'competitiveness' in the EU. First, the usual meaning of competitiveness concerns *companies*. Of course, companies have strong incentives to stay 'competitive', otherwise they will not survive in the market place. EU policies should ensure and maintain a pro-competitive environment over the entire Union in which markets can thrive, while minimizing market failures and paying careful attention to fundamentals such as infrastructure and macro-economic stabilisation. Clearly, this is of great importance at the national level, too.

The single market disciplines Member States in this respect but the reduced national regulatory autonomy is nevertheless still pretty important: a pro-competitive environment has to be ensured nationally as well. Moreover, EU countries have significant discretion on tax powers, the welfare state and many other aspects, which may or may not be conducive to 'competitiveness' of enterprises. The very open trade and investment policy of the Union has long exposed EU companies to external competition and massive incoming FDI[48], which has stimulated EU business to retain high performance in many sectors.

The competitiveness union, or, the integrated framework for competitiveness brought up under the flag of a 'genuine EMU', is not really about this. Broader issues of competition policy, the single market, some common policies in trade, energy, transport, innovation all matter, but there is no compelling link with the genuine EMU.

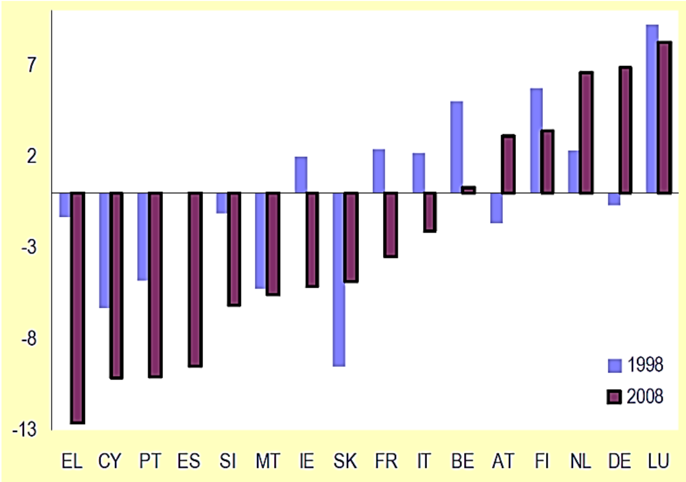
They would equally matter without a common currency. The second meaning of 'competitiveness' is a *macro-economic* concept. In the crisis it became associated with 'macro-economic imbalances' in the Eurozone. In the first decade of the euro, countries such

[48] Of course, also outflows of FDI and FDI stocks owned elsewhere in the world tend, on the whole, help European companies to stay competitive.

as Greece, Spain and Portugal (Italy to a lesser extent) built up secular current account imbalances inside the euro area (see Figure 5).

Figure 5. Macro-economic imbalances on current accounts of Eurozone countries

(before the crisis, 1996 – 2006)



Source : European Commission (2009)

This is likely to imply two things : first, given the absence of nominal exchange rates inside the euro area, the expected adjustment processes via the real effective exchange rates [49] did not seem to work effectively because no corrections emerged even after a decade.

Second, such steady imbalances have to be financed and apparently, in the Eurozone, banks and other suppliers of funding were happily financing net positions (at Eurozone interest rates) until the crisis broke out, without too many worries about bubbles and exposure to risk. In the early phase of the crisis, the prospects for many private investment plans were re-assessed. This led to a collapse of construction and other subsectors, and with it to insolvencies, in turn, leading to many non-performing loans with numerous banks in the rest of the Eurozone.

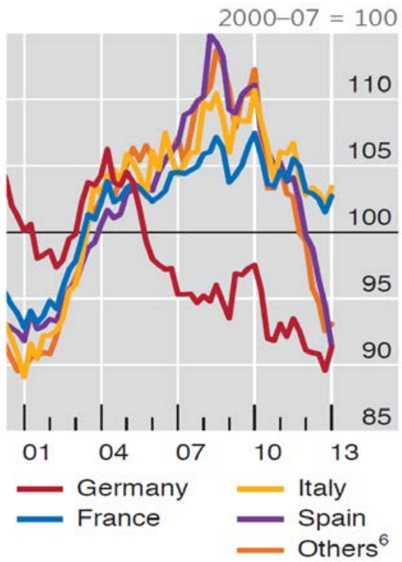
Later analysis clarified that, in part, this 'lack of (macro) competitiveness' was also due to wage increases (for years) paid above the growth of productivity, an unsustainable strategy. Nonetheless, much was attributed to the lack of competitive exposure in 'sheltered' non-tradable sectors and to rigidities in adjustments, calling for deep national reforms. The basic problem in the EU /Eurozone is that such reforms are typically involving many national policy competences. Resistance to deep reforms can thus negatively affect the Eurozone, in particular , its macro-economic record via these interdependencies. That is the reason why the macro-economic imbalances procedure has been introduced, in order to pre-empt a refusal to reform, to follow reforms closely and the minimize the consequences, even though many reforms fall under domestic powers.

[49] This is a complex area of economic analysis. For present purposes, such adjustments via REERs may take several forms or combinations, e.g. wage and/or price reactions, relative sectoral wage and price movements, shifts between tradable and non-tradable, etc. , in turn, requiring a considerable degree of market flexibility for such processes to work smoothly.

However, in the case of the MED countries, the rescue finance they received (Greece, Portugal) or the attempts to prevent such rescue funding (with all its strict conditionalities) (Italy, Spain), have led to faster and more immediate reforms under pressure. In a way, one might interpret this as a late attempt to enhance market flexibility in the currency zone so as to improve adjustment processes[50]. Although of course the term 'competitiveness union' makes no sense, it is true that the crisis has confirmed the need for close coordination of national economic policies in the Eurozone for their common collective good (the euro) to remain of high quality. A lack of macro-economic 'competitiveness' in the precise sense of avoiding secular current account deficits inside the Eurozone is one of the leading concerns.

The new macro-economic imbalances procedure (MIP) in the six-pack is designed to address the issue[51] . Most structural reforms fall under national powers but the MIP has introduced light sanctions at the end of the road. One might interpret the MIP approach to (macro) competitiveness as an incentives-based rather than a sanction-based approach[52]. This is confirmed by a recent Commission proposals on a convergence and competitiveness instrument as well as on tighter coordination[53]. At the same time, it should be realized that the *current* adjustment of imbalances is hardly or not determined by the impact of the ongoing structural reforms in MED countries, but rather by costly one-sided contraction of the deficit countries (see Figure 6, showing very fast improvements for MED countries and Ireland, essentially by sharp contraction).

Figure 6. Restoring macro-economic competitiveness in the Eurozone



Source : BIS (2013, 21). Macro-competitiveness here is based on the ECB indicator : effective exchange rate vis a vis major trading partners and other euro area members, deflated by unit labour costs. Others = P, IRE and GR.

[50] As suggested by certain elements of the optimum currency area theory.

[51] The macro-economic imbalances procedure is found in Regulation 1176/2011 of 16 Nov. 2011. For the complicated Scoreboard for its surveillance, see European Economy, Occasional Papers 92 of February 2012. The regular Alerts have been both on secular deficits on the current accounts and on surpluses (like the newest Alert of 13 Nov 2013, e.g. on Germany ; see Gros & Busse (2013) for critical comments).

[52] See e.g. Gruener (2013) and Vandenbosch (2013)

[53] See European Commission (2013c ; 2013d).

6.3 *The 'social union'*

The 'social union' is not a concept that fits today's EU or, for that matter, the Eurozone. The term 'social union' was employed when Germany entered the process of unification of East and West Germany in 1990 based on a political, monetary and social union. This made sense, even though the specific terms of this 'union' were undoubtedly far too optimistic[54] at the outset. It made sense because the new Germany is one single country, with a common centralized tax system (based on the full recognition of solidarity between Germans) and with one regime of social charges and allowances, with a single labour market and a single welfare state.

Nothing even remotely similar applies to the EU. The EU has few powers in social policy, harmonisation in some domains (e.g. social security) is even forbidden, its social/ labour regulations are practically all minimum 'standards' (except occupational health and safety), the relations between the social partners exist at both national and EU level but are strictly national when it comes to wages settlements and some other aspects, EU cannot tax or impose social charges and it has no budget whatsoever to pursue even a minimalistic welfare state. A subsidiarity test would swiftly find that this current state of affairs is justified and rational, given limited cross-border movement of workers, very diverse preferences between EU countries as well as different levels of development, which would (in case of a social union) imply major cross-border social transfers.

Why then the call for a 'social union'? There has long been a fear that, without either budgetary or binding coordination instruments at EMU level, the euro would have the effect of undermining partially the national socio-economic 'compacts' (implicit or explicit) in participating Member States.

This fear has arisen from a combination of strict budgetary discipline and 'internal devaluation' (via the REER, often by wage cutting and labour shedding) as the dominant form of intra euro zone adjustment, in the absence of exchange rates. Since the crisis, the model of national budgets generating macro-economic stabilisation via offsetting spending has proven a failure. Of course, this could have been prevented, had there been sound supervision of banks and strict adherence of the SGP. But the fact is that that did not happen and the new architecture of EMU is meant for a future crisis, or, rather to prevent or minimize a future crisis.

So, the defects of EMU and a sad lack of effective decision-making led to a sharp hike in poverty rates precisely in the MED countries, as well as intolerably high youth jobless rates together with abrupt cuts in welfare states expenditures in a zero growth situation. Even the better performing euro countries saw their budgetary strategies falter due to bank rescues. The upshot was a pro-cyclical common move of imposed austerity with negative cross-border spill-overs. Hence, a plea by some to set up some shared fiscal capacity of one kind or another, or an EU unemployment fund, so as to substitute at EU level for the current lack of stabilisation capacity at national level. Very cautiously, the European Council has agreed to

[54] In particular, not only extending the West German welfare state to former East Germany but in addition pushing very rapid wage increases for the East far above their productivity levels at the time.

more agile monitoring (with scoreboards and ‘more’ attention for social aspects in EMU, including more involvement of social partners e.g. in the European semester).

According to Commissioner Andor (social affairs), the Commission is even preparing a technical study of an EU unemployment benefit scheme[55] but whether this would be voted through any time soon and properly funded seems everybody’s guess. To begin with, the Lisbon treaty lacks a legal base for it. For it to have non-trivial stabilisation effects, the funding ought to be bigger than Member States would allow; for it not to develop into permanent transfers – given the grassroots resistance to such a course in many euro countries – its design would have to be like an insurance fund.

The fundamental problem is that the EU or the Eurozone is not ready for such (even minimal) fiscal federalism. The better design of (the genuine) EMU should result in less dramatic slumps in future, but the social pain will remain at the level where the competences are: the Member States. Some other authors[56] envisage a cooperative European Social Union, giving the EU an explicit social purpose, with e.g. minimum social standards (but national models applying those), greater social investment and more mainstreaming of the social dimension in all EU policies. Eurozone adjustments ought to be more balanced between deficit and surplus countries. However, one can also take the view that the best EU social policy in the Eurozone is to firmly pre-empt such crises, and the very costly pro-cyclical handling of it, by better justified rules, supervision and the preventive policies of the MIP and faster decision-making on rescue funds and the like. In other words, even when new crises might occur, they would be far less deep and the Eurozone capability to tackle the issues would prevent so many job losses and social misery.

6.4 *The political union*

‘The’ political union is little more than a label, which may hide almost any concept. But this is not merely an academic luxury, there is also a painful precedent. It should be remembered that the EU established a negotiation track on ‘political union’ during the 1990 process leading to the Maastricht treaty, besides the track on EMU. Exactly the same absence of even the most elementary commonness of purpose or design compelled political leaders to stop this negotiation track after 9 months. This is not to say that EMU and its implications are somehow a-political. Of course they are not, but the core issues are about political legitimacy as well as accountability and there are many ways to address this. For some economists[57], political union is a direct corollary of EMU: it means a carefully circumscribed

[55] Andor (2013). In European Commission (2013e, p. 11) some first suggestions on how the Commission is thinking are indicated. For a wide-ranging survey of all aspects of the social dimension of EMU, see Fernandes & Maslauskaite (2013).

[56] Vandenbroucke (2014), a former Belgian labour minister; and Roth (2014), currently a minister in Germany, find that EMU should be complimented with a highly decentralised Social Union, with explicit reforms agenda’s as well, and balanced macro-economic adjustment (also for surplus countries in the Eurozone).

[57] A prominent author is Paul de Grauwe. For De Grauwe (2013), ‘political union’ would signify three critical changes in EMU governance. First, given the now accepted role of the ECB as lender of last resort, some degree of partial debt pooling ought to be accomplished (shows that euro countries ‘are serious in their intentions to stick together’). There are ways of doing this without much of a risk to tax payers of the stronger euro countries. Second, macro-economies policies, in particular for adjustment, have to become more symmetric. Putting the adjustment burden in a one-sided manner on deficit countries has created a deflationary bias and is

and selective shift of economic, spending and/or tax powers to the EU or Eurozone level, more balanced macro-economic adjustment and some debt pooling or sharing risks.

If defined in such a way, this would undoubtedly require some political decision-making at EU or Eurozone level, but why call this a 'political union'? Or, perhaps for others, why call it an EU economic government? As if today, no political decisions on such matters are taking place. On the one hand, as the crisis has demonstrated clearly, the European Council and the Euro Group have been taking decisions of a highly political character all along. And it is also undeniable that they have dramatically shifted their priorities, if not mind sets, about EMU and desirable degrees of centralisation.

On the other hand, it so happens that precisely such powers – even when shifted in modest degrees – are politically very sensitive with voters (read: tax payers) and many domestic politicians. Giving the EU (even limited) tax power or a much higher budget will decisively *not* generate more political legitimacy. The now agreed (limited) degrees of debt pooling via bank resolution and the even more circumscribed pooling via borrowing from national deposit guarantee systems is only accepted precisely because it is very small in the longer run (if the system works as foreseen) and not applicable in the very short run. An EU-wide deposit guarantee insurance system has been removed from the EU agenda for the time being: that would strengthen risk pooling but is not feasible.

Moreover, the notion of 'political union', already vague and too easily subject to many interpretations, has not only been advocated as a result of 'fiscal union' (in the Eurozone or beyond) but recently also with respect to the new powers of the ECB. For example, De Grauwe & Ji (2014) suggest yet another variant of the 'political union' idea, as a corollary of EMU, when they argue "… that the ECB is the ultimate guarantor of sovereign debt in the Eurozone". As lender-of-the-last-resort (given OMT), the ECB should be made subordinate to the political power of elected politicians (as is the case in the US or the UK), because, in the case of a crisis, the sovereign has primacy over the central bank. In contrast, at the moment the ECB is fully independent, i.e. the ECB has primacy over the sovereigns; the ECB may help sovereigns as lender-of-the-last-resort but this is not guaranteed as the result of a politically legitimate preference of EU/ Eurozone countries' governments.

This interpretation shows once again that 'political union' is a highly elastic notion: it might be thought necessary for reasons of domestic economic reforms in EU countries, for a larger common budget, for some EU tax power, for (greater) risk pooling, for 'symmetric' macro-economic adjustment and for some ultimate control of the ECB in times of crisis. Taking each one of these arguments separately, a range of more typical EU solutions might be found without suggesting a 'political union'. Taking them together would be different: in such a thought experiment, it seems hard to avoid the idea of much greater Europeanization

largely responsible for the double-dip recession, with great risks of social and political disturbance in some countries experiencing traumatic falls in real income and huge unemployment. Third, the long-run sustainability of the Eurozone depends on a fiscal union, not without but *with* some capacity of macro-economic stabilisation. De Grauwe even speaks of 'significant spending and taxing powers' for the EU or the Eurozone. This might be linked with major resolution funds (with qualified majority voting!). Variations of this view have been presented by other colleagues.

of ‘economic government’, whatever that might mean exactly. But just as ‘fiscal capacity’ was long an all-or-nothing taboo for shifting bank resolution to the EU level, now solved with a common Fund, other carefully targeted responses can be designed for the various aspects where seen as indispensable. For instance, even for the lender-of-last-resort function of the ECB, rather than deciding on a heavy-handed ‘political union’, a simple deal could be engineered at EU level, as follows: the lender-of-last-resort function is legally incorporated in the statutes of the ECB, in exchange of adding an article similar to the ‘crise manifeste’ of the ECSC (art. 58). The latter article would make it possible, under strict institutional requirements, for the European Council, upon a substantiated proposal of the Commission (for which some minimum conditions would have to be fulfilled), to declare a ‘manifest crisis’ in the Eurozone or wider, which would give it authority to temporarily overrule the ECB, if there were a need of ample liquidity and the ECB would resist that. The power might perhaps never have to be exercised but the joint sovereigns would have ‘primacy’ when it matters. To call that a ‘political union’, however, seems far-fetched, whilst the ECB arsenal of instruments would no longer be controversial.

The question is whether today’s fiscal union, as discussed, and a fully-fledged banking union would suffice. This seems hard to answer as economists are divided on what is indispensable for EMU to serve the EU or Eurozone economy properly in the longer run. Critical here is the term ‘fully-fledged’, implying an EU-wide deposit insurance scheme backing up resolution powers as well as rapid decision-making about near-insolvent banks. Again, in the near future when risk pooling will be less risky, such a common system might become feasible. Again, to call that ‘political union’ is neither helpful not clarifying.

For many others, mainly political scientists and politicians, the focus should be on the political side, referring to various ambitions of organizing political legitimacy and accountability at EU level or at least for the Eurozone on a permanent basis. In a recent summary of such proposals[58], a host of suggestions falls under this heading. Critical are the recognisability of euro decision-makers to voters (a single face for the euro), a single presidency of the EU (Commission and Council president the same person), election of the president by the EP, greater proportionality of seats in the EP (implying that larger countries carry more weight than today), creation of a Eurozone assembly (with some prerogatives and strengthening accountability), a residual role for the EP in excessive deficit procedures and several proposals to give national parliaments a direct role (e.g. together with the EP or some of the latter’s committees) in EMU affairs, in addition to their current role in the European semester at home. Without necessarily being against these types of proposals, one can maintain serious doubts whether the marginal changes at the EU level generate the legitimacy that is desired. The exception is found in a greater role of national parliaments. The question there is how to do this effectively.

It is important to observe that these two new forms of thinking on ‘political union’ seem to be moving on parallel tracks, without being linked. However, it goes without saying that a considerable shift of spending and some tax powers to the EU or Eurozone level is impossible and undesirable without concomitant political representation powers: ‘no

[58] Chopin, Jamet & Priollaud (2012). For a quite pessimistic view on political legitimacy, see Crum (2013).

taxation without representation'. Surprisingly, this crucial insight seems (still) absent in both tracks. Bringing national parliaments in might help, dependent on how this is done. But a new treaty amendment precisely about such aspects would appear to be out of the question at the moment; if not the drafting of an agreed text (say, in a Convention), then in any event in the ratification, including some ten or more national referenda. Moreover, one might also connect these considerations with a more intense EU social dimension, e.g. an EU unemployment fund or specific tasks with respect to youth unemployment (as recently expanded in a modest way by the European Council with a budget of € 8 bn) and/or a greater role of social partners in EMU.

7. Conclusions

The EU is presently going through a genuine transformation, on the road to a 'genuine EMU'. The crisis and its aftermath in Europe have broken some political, regulatory, institutional and monetary taboos, altered preferences of Member States and generated a strategic long run vision of what a 'genuine EMU' implies. There is a deep ambiguity in Europe about a 'genuine EMU'. On the one hand, zero or negative growth at first and the slow emergence from the second 'dip' as well as the depressively high unemployment in many EU countries prevent a wide recognition of this remarkable transformation. Most of all, this is true at the grassroots level – rightly or wrongly, few people care as the euro(zone) has lost too much credibility given the misery it seemed to have caused. On the other hand, the many changes already introduced in the budgetary and institutional 'acquis', the progress on the banking union (including some 'fiscal capacity' at EU level for bank resolution) and the amazing evolution of the tasks and influence of the ECB have not fully removed doubts about the sufficiency of the accomplishments. These doubts concern the shifts of economic powers, the tendency to go 'intergovernmental' or the democratic legitimacy and accountability of process and overall socio-economic strategy.

Progress has surely been made and it is impressive for EU specialists realizing where EMU governance and substance came from only 5-6 years ago. One of the astounding aspects consists of the steady further deepening and widening of the single market, too little noticed and perhaps too splintered in the many steps ahead, but eventually of importance as the foundation of a sound EMU. And this despite the Great recession. But precisely in the financial internal market, a severe setback has occurred and it is crucial that this setback be reversed fully. The fiscal union, as agreed step by step, signifies considerable progress in terms of budgetary disciplines and a breakthrough with respect to fiscal capacity for bank resolution powers combined with 'bail-in'. The EP has reduced the intergovernmental and counterproductive complexities of the Banking Union, as preferred by Member States, somewhat.

The banking union has been accomplished with respect to better supervision (rules and centralisation), EU level resolution powers and funding (again, based on bail-in first). But some turbulence might be expected when the ECB tests (on the assets quality review and later stress tests) find (big) banks that are technically insolvent and will have to restructure, merge, be recapitalised or die. Precisely in this early period the resolution funds are not yet available, risking a confrontation with the Member States.

However, recognizing the transformation of EMU and related EU-wide banking supervision and resolution, is one thing. The initial framing of the ‘genuine EMU’ was nevertheless oversold, suggesting that a parade of other ’unions’ would be needed in its wake.

A review of four ‘unions’ – economic union, competitiveness union, social union and political union – brings out that this kind of framing is at the very least not useful, if not misleading. The first two are anything but clear and the issues involved are not new. The macro-economic imbalances procedure (MIP) and the ESRB are worthwhile improvements over the pre-crisis disregard of macro competitiveness and of systemic risks. The three components of what presumably is an ‘economic union’ (single market, economic policy coordination and budgetary disciplines) have all been strengthened step by step. The last two ‘unions’, on the other hand, would imply a fundamental change in the conferral of powers by the Member States to the EU /Eurozone, with drastic long-run implications. Hence, neither a social nor a political union worthy of the name will be pursued. There are solutions to the issues often said to be in need of a ‘political union’, which are targeted, without being too intrusive or quasi-federalist.

At present, the EU leadership only discusses some marginal changes seriously. There is a risk in this paralysis, as political legitimacy (‘we have never been asked’) and accountability undoubtedly have to be strengthened, especially via involvement of national parliaments. At the same time, it is also crystal-clear that, nowadays, it will be very difficult to strengthen convincingly EMU’s political legitimacy with the grassroots. The core problem for the grassroots is their disillusion with the political elites in Europe, national and European alike, but the EU remains an easier culprit.

There are many reasons for this disillusion but one is certainly the lack of direct and serious debates about the EU and the euro at grassroots level. Only eurosceptics do this, as they attempt to organize the discontents. But even the BREXIT debate in the UK, where the eurosceptics had some difficulty in arguing their case on facts, has not helped much, as their voters tend to vote emotionally. The new European Parliament will have to cope with eurosceptics in much larger numbers than before. This will sharpen the debate about the ‘genuine’ EMU, although it need not render the process of completing the ‘genuine EMU’ more difficult, given the large majority of MEPs interested in making the euro and the single market work better and given targeted solutions to specific aspects of EMU. What is more problematic in such an environment is to argue for still more unions, let alone unions which are nebulous and subject to many interpretations, and which are either not necessary or can be solved in an effective, targeted fashion.

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