Policy Contribution
Issue n˚23 | September 2017

Europe's fourfold union: Updating the 2012 vision

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Executive summary

- **THE DEPICTION** of the euro area/European Union (EU) as a 'fourfold union' (financial union, fiscal union, economic union, political union) emerged in the first half of 2012 at the height of the euro-area crisis. It was primarily shaped by the recognition of the bank-sovereign vicious circle and the need to break it to ensure the survival of Economic and Monetary Union (EMU).

- **THIS FRAMING** of EMU and EU integration is inevitably simplistic but its four-part categorisation remains relevant and useful when assessing current and future challenges to European integration.

- **IN THE** past half-decade, Europe's financial union has been significantly strengthened but remains incomplete and is challenged by the expected exit of the United Kingdom (Brexit). No consensus has been found on fiscal union, and the existing fiscal framework based on administrative control is problematic. Economic union has not made material progress. Political union, a more intangible notion, might have advanced further than many observers realise, even as national politics remain paramount for the vast majority of EU citizens.

- **A NEAR-TERM** agenda to strengthen EMU, for which decisions could be made in the course of 2018 and without any treaty change, should rest on a balance of further risk-sharing and enhanced market discipline, building on the significant risk reduction achieved over the last half-decade. At the heart of this next step of integration would be regulatory curbs on banks' sovereign exposures in the euro area and a European deposit insurance scheme. Complementary initiatives should include, on the fiscal side, a reform of the accounting and auditing framework that applies to euro-area member states, and on the (structural) economic side, a new architecture of sector-specific EU authorities to enforce the single market in regulated industries.

- **A MORE** ambitious vision would have to include the European pooling of selected tax revenue streams to support an incipient fiscal union. The corresponding policy debate, however, might be best delayed until after the next European Parliament elections in June 2019.

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A version of this material was originally published as a written statement prepared for the Expert Meeting on Deepening the Economic & Monetary Union, Dutch Tweede Kamer, Finance Committee, The Hague, 13 September 2017. The author is also an independent board member for the derivatives trade repository arm of DTCC (Depository Trust & Clearing Corporation), and an individual investor in three venture capital funds managed by Newfund. The author does not view any of his affiliations and investments as creating a conflict of interest either for his research or in the context of the Expert Meeting. More information is available on www.bruegel.org.

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The emergence of the fourfold-union vision in 2012

The transformation of the EU economic and financial policy framework in the wake of the last decade of crisis has been enormously complex, and it is easy to get lost in the details. The euro area's endeavour of monetary and economic union of politically sovereign countries is historically unprecedented. Its initial design was incomplete. Its early development can be viewed as something of a collective discovery process; no expert fully anticipated the way the vulnerabilities of Economic and Monetary Union would play out under duress. The description of the related challenges through the analytical lens of the fourfold union crystallised in the first half of 2012 at a time of acute stress, and remains relevant.

The key insight gained during the most disruptive phase of the euro-area crisis, particularly after its escalation in the summer of 2011, was the realisation that the direct and indirect financial linkages between national governments and national banking systems, also known as the bank-sovereign vicious circle, or colloquially the 'doom loop', had become the central vulnerability in a context of general uncertainty about the future of the euro area.

This realisation was gradual. In the first few years of the financial crisis that started in mid-2007, there was near-universal denial in euro-area countries of the largely home-grown nature of the problems encountered. Specifically, national banking supervisors had perverse incentives to neglect the build-up of risk in domestic banks, as they tended to promote and defend these same banks as 'national champions' on the increasingly open European competitive playing field. The appearance of sovereign credit risk in the euro area was not immediately connected in the European public policy debate with banking sector fragility, partly because the country in which that risk manifested itself first and most strongly, Greece, was an outlier in terms of its domestic banks not appearing to have taken excessive risks of their own.

From an analytical standpoint, the bank-sovereign vicious circle appears to have been first identified in 2008-09 by International Monetary Fund (IMF) staff economists (Mody, 2009; Sgherri and Zoli, 2009). Their insights were based on close observation of developments in Ireland, a textbook case of contagion from the domestic banking sector to the national sovereign, in the wake of the Irish government's provision of highly generous guarantees over the domestic banks' liabilities in October 2008. In the period that immediately followed, the IMF was partly distracted from this stream of analysis by the intensity of the Greek crisis, but other analysts and scholars made similar observations. With the raising of systemic concerns in Spain, Italy and France during the course of 2011, the bank-sovereign vicious circle became an increasingly evident and widespread framework for analysing the crisis. By early 2012, it had become a mainstream reference included in public policy pronouncements[1].

The European Union's inability to stem the contagion through the bank-sovereign vicious circle in turn exposed its lack of effective executive decision-making capacity. This EU 'executive deficit' itself formed a vicious circle with its more familiar democratic deficit: not only did the EU institutions' lack of authority prevent them from solving the crisis, but their incapacity to do so also fed the European public's distrust of them (Véron, 2012). The crisis thus came to be seen as a test of the political commitment of individual member states and their citizens to the overall European integration project.

Things came to a head in June 2012. The short-term catalyst for this moment of reckoning was the rapid deterioration of market perceptions of the Spanish banking sector following the forced nationalisation of Bankia, a large and troubled bank, in May. Simultaneously, the outcome of the Greek parliamentary election on 17 June, following a turbulent national political sequence, sent a strong signal that Greek voters did not favour an exit of their country from

1 See Véron (2016a) for references.

the euro area, which in turn created space for all member states to proclaim their willingness to hang together.

The 'Four Presidents' Report' of 26 June 2012, brought these strands together and crystallised the vision of a fourfold union (Van Rompuy, 2012a). It was prepared by the President of the European Council, Herman Van Rompuy, in close cooperation with his peers at the European Commission (José Manuel Barroso), the Eurogroup (Jean-Claude Juncker) and the European Central Bank (Mario Draghi), thus its name. It proposed *"a vision for a stable and prosperous EMU based on four essential building blocks: An integrated financial framework [...] An integrated budgetary framework [...] An integrated economic policy framework[2] [...] Ensuring the necessary democratic legitimacy and accountability of decision-making within the EMU"*. Echoing contemporary references in the public debate, these four items were immediately referred to as banking (or financial) union, fiscal union, economic union and political union, a summary Mr Van Rompuy did not discourage[3].

Three days later, on 29 June, the euro-area heads of state and government announced their decision to create a banking union, with the words *"we affirm that it is imperative to break the vicious circle between banks and sovereigns"* (Euro Area Summit Statement, 2012). Starting with a fiscal union would have been an alternative way to address the bank-sovereign vicious circle, and had been widely advocated the previous year not least in Germany[4]. But ultimately this came to be seen as impractical in the context of Europe's existing economic and political structures. By contrast, the commitment to a banking union could be enshrined in firm, game-changing decisions without entailing immediate and explicit financial risk-sharing, let alone treaty change. Accordingly, the creation of a Single Supervisory Mechanism (SSM) with its hub at the European Central Bank (ECB) was the centrepiece of the 29 June announcement.

In the immediate aftermath of this breakthrough, policymakers acted as if they had done enough to stabilise the situation. The pledge to allow the European Stability Mechanism (ESM) to participate in direct bank recapitalisations after the SSM's 'effective' establishment, also included in the leaders' statement of 29 June 2012, was later rowed back on and eventually voided by imposing conditions that are so onerous that the instrument may never be used (ESM, 2014). Meanwhile, the Bank Recovery and Resolution Directive (BRRD), proposed by the European Commission earlier in June 2012, was tightened during the legislative process. This allowed political leaders to proclaim that the past practice of national bank rescues using taxpayers' money could be replaced in the future by pure market discipline involving the financial participation (or 'bail-in') of failing banks' creditors and other claimants, without having to create a meaningful safety net at the European level. Meanwhile, the Spanish situation was addressed by an assistance programme that was finalised on 20 July 2012, and involved the ESM lending to the Spanish government so it could recapitalise Spanish banks to the extent needed.

Even though it was only partially implemented, the fourfold-union vision had become a powerful reference to frame subsequent debates about EMU reform, and remains relevant to this day. It is inevitably simplistic and imprecise: each of the four 'unions' can mean different things to different people. Nevertheless, the respective and separate areas of financial services policy, fiscal policy, structural economic policies and political institutions together cover most of the ground on which further reform can make EMU more resilient. Because they are partly interdependent, progress in one area can feed progress in others. The fourfold framework is thus useful both to assess progress made since the seminal episode of mid-2012, and

2 In the Four Presidents' report, this item was not defined as precisely as the other three, but the indications were that it would refer mostly to structural economic policies.

3 A follow-up report in the same format six months later (Van Rompuy, 2012b) referred to the evolution of EMU "towards banking, fiscal and economic union". See also Véron (2012).

4 See eg Zeit Online, 'Merkel will Fiskalunion ohne Volksabstimmung', 2 December 2011, available at http://www.zeit.de/politik/deutschland/2011-12/euro-merkel-volksabstimmung.

to outline future steps that might be needed to ensure EMU sustainability.

In terms of geographical scope, none of the four categories is strictly restricted to euro-area countries. Financial services regulation is mostly provided under the EU internal market policy framework and thus applies to the entire European Economic Area (EEA). Many aspects of the fiscal and structural economic policy coordination framework, including the European Semester for review of national policies, apply to all EU member states, even though others are euro-area only. The most powerful EU instrument for structural economic reform, at least for countries not undergoing an assistance programme, is the bloc's long-standing internal (or single) market policy, which is EEA-wide by definition. And the union's existing political and judicial institutions are all at the EU level, not the euro area. Tensions between euro-area-specific concerns and the existing construct of the European Union are thus inherent and pervasive in the vision of the fourfold union.

A half-decade of developments: 2012-17

In this section, the fourfold analytical framework of financial, fiscal, economic and political federalism in Europe is applied to provide a highly summarised description and holistic assessment of developments in the last five years.

Financial sector

Based on the landmark decision of 29 June 2012, the SSM was rapidly established and on 4 November 2014 assumed its supervisory authority over all euro-area banks (directly over the larger ones and indirectly over the smaller ones). The SSM is now a widely respected supervisor, to the extent that Stockholm-based Nordea referred to the SSM's credibility when announcing in September 2017 its decision to move its headquarters to Helsinki in the banking union area[5]. In addition, the euro area's leaders in December 2012 decided to complement the SSM with a Single Resolution Mechanism (SRM) centred on a new agency, the Single Resolution Board (SRB), with a Single Resolution Fund (SRF) at its disposal. The SRB became fully operational in January 2016 and rather successfully passed its first real-life test with the resolution action it took in early June 2017 in relation to Banco Popular Español.

More broadly, the last five years have seen the euro-area banking sector shift from a state of acute fragility in mid-2012 to a significantly healthier, though not fully recovered, condition as of September 2017. With often painful action in the meantime in countries including Austria, Cyprus, Greece, Italy, the Netherlands, Portugal, Slovenia and Spain, the risks have been shifted from the country level to the bank level. In other words, a number of banks will probably require further restructuring that in some case might lead to their resolution or liquidation, as was the case with Banco Popular. However, none of these is likely to lead to an immediate revival of the bank-sovereign vicious circle in a manner that could threaten the corresponding country's sovereign debt market access. Though many details are debatable and there are plausible arguments that the clean-up of the sector could have been achieved more quickly and at lower public cost, there is also little doubt that this process of reinstating trust in the banking system was facilitated by the early implementation of banking union and especially the build-up of supervisory capabilities at the SSM.

The banking union, however, remains a work in progress and can in no way be described as having achieved the stated *"imperative to break the vicious circle between banks and sover-*

5 See for example Simon Johnson and Johan Ahlander 'Banking group Nordea snubs Sweden with HQ move to Finland,' Reuters, 6 September 2017, available at https://www.reuters.com/article/us-sweden-nordea/banking-group-nordea-snubs-sweden-with-hq-move-to-finland-idUSKCN1BH28R.

eigns". The most direct financial linkages, from banks to sovereigns through national deposit insurance schemes and from sovereigns to banks through the high home bias observed in most banks' sovereign exposures, have remained broadly unchanged since 2012. Less direct links are also pervasive and unchanged since 2012, including lingering implicit or explicit national guarantees of bank liabilities other than insured deposits[6], the concentrated geographical footprint of many medium-sized and large European banks that exposes them overwhelmingly to a recession in a single country and, as is the case for many banks, governance and ownership structures that create high dependencies on national politics and policy.

The initial successes of the banking union project have also emboldened the European Commission to promote a more ambitious integration agenda for the entire financial sector, dubbed Capital Markets Union by Jean-Claude Juncker who announced it in his maiden policy speech as president-elect of the European Commission in July 2014. While the concrete policy achievements of this initiative have been underwhelming so far, it has nevertheless reframed the public debate about capital markets and possibly paved the way towards an expanded role for the European Securities and Markets Authority (ESMA) to become the direct supervisor of an increasing number of market segments and enforcer of an increasing number of capital market rules in the near future, even though ESMA is currently under-resourced and its governance was not designed for such a role.

Fiscal framework

The ESM, which was formally created in the course of 2012, has now established its credibility as an emergency lender to countries and is increasingly able to manage assistance programmes, including policy conditionality, on its own – even though no such programme has been granted so far without any IMF involvement. In the course of the past half-decade, the ESM and its creditor partners were able to bring an end to the programmes in Ireland, Portugal, Spain and Cyprus. The ESM will, however, remain involved in Greece for the foreseeable future.

At the legislative level, the EU fiscal framework has remained fairly stable since 2012, following the numerous changes introduced in the previous two years (chronologically the so-called 'six pack', 'two pack' and Fiscal Compact). The corresponding process of administrative review and assessment by the European Commission has arguably fostered greater discipline and facilitated comparisons between countries, but has ultimately been exposed as unenforceable or at least unenforced, since the European Commission has refrained from using its ability to apply financial sanctions in cases of non-compliance.

Meanwhile, uncertainties linger over the integrity of the production of government accounts and statistics at the national level, despite reforms introduced since the egregious malpractice revealed in Greece in 2009 (and earlier in 2004) led to very significant restatements of key ratios such as government deficit to Gross Domestic Product (GDP). Eurostat has been granted greater powers to double-check numbers in case of doubt, but ultimately cannot ensure the integrity of national accounting and statistical processes. A particularly troubling case has been the multiple prosecutions of Andreas Georgiou, head of the Greek statistical office from 2010 to 2015, in a highly charged political climate and despite repeated warnings from EU officials[7].

6 The European Commission's current interpretation of its state aid control mandate, last set out in a Communication of July 2013, practically prohibits such guarantees on equity and subordinated debt, but not on senior debt or uninsured deposits. The liquidation of Banca Popolare di Veneto and Veneto Banca in late June 2017, in which all senior creditors were fully reimbursed, illustrated the lingering willingness of at least some member states to use this flexibility even at a high cost in terms of taxpayers' money.

7 See eg Jim Brunsden, Arthur Beesley and Kerin Hope, 'Eurozone officials warn on Greece statistics trial "farce"', Financial Times, 3 August 2017, available at https://www.ft.com/content/3d213384-77b1-11e7-90c0-90a9d1bc9691.

Structural economic policies

Even more than on fiscal behaviour, the European Union has struggled to establish new mechanisms that would lead to better and more consistent structural reforms in individual member states, leaving aside those under an assistance programme. The Euro Plus Pact of 2011, which sought non-binding mechanisms under the so-called open method of coordination, did not achieve tangible results. The idea of complementing the review of structural reforms embedded in the European Semester with 'contractual arrangements', in which member states would commit to specific reform projects against European financial support, appears unlikely to be ever implemented following lengthy and essentially fruitless discussions since its early formulation (eg Van Rompuy, 2012b).

The EU single market framework needs to adapt to a changing environment, particularly in the face of the emergence of major global players in digital services and the increasing share of inward foreign investment from countries with significantly different political and security approaches

Meanwhile, the European Union's most powerful structural economic policy instrument remains its single market framework, complemented by assertive competition policy enforcement by the European Commission and its national counterparts. In this area too, the European Union needs to adapt to a changing environment. Two trends in particular are challenging and have been met so far by only partial responses at best. The first is the emergence of major global players in digital services that represent an increasingly significant component of the social fabric, namely a handful of large digital and social media platforms which enjoy dominant positions in their respective markets and are typically not as highly regulated in their home jurisdiction, the United States, as they might be in Europe. Among other things, this generates a risk of single market fragmentation as different member states or even local governments adopt sharply divergent approaches to these companies' services, often under the guise of important and legitimate concerns such as individual privacy but sometimes also motivated by special interests, as has been the case variously with Airbnb and Uber among others. A second challenge is that an increasing share of inward foreign investment into the European Union comes from countries with political and security approaches that are significantly different from those of the European Union: primarily China but also others such as Russia or the Gulf countries. Whereas it would be a mistake to close Europe to such investment or to create an inherently unpredictable investment environment, there are also legitimate security concerns. The existing policy framework does not accommodate these in a manner that is consistent with the freedoms embedded in the internal market (see Röller and Véron, 2008).

Political cohesion

Of the four areas of the fourfold-union vision, this is the least technical, the least precisely defined and also certainly the most important. The conventional wisdom is that EU political cohesion was impaired during the crisis by poor policy decision-making at the EU level, the lack of alignment of interests between different countries and the rise of populist anti-EU parties in an increasing number of countries. The June 2016 UK referendum vote for Brexit unquestionably supported this narrative, as have recent developments in which the rule of law as defined in EU treaties has been questioned in Hungary and Poland.

A bleak narrative of EU political disintegration, however, fails to account for other observations. The most obvious is that despite many prophecies of its imminent demise, the euro area has kept its integrity. Whether the euro area could survive the exit of any of its member states remains a matter of debate, but the fact is that none has exited so far even in dire circumstances such as those of Cyprus in March 2013 or Greece in early July 2015. While this experience should not lead to complacency about the euro area's sustainability, it suggests that, in spite of all the vocal disagreements and cultural differences, the political forces holding it together are very strong.

The euro area's survival capacity is not the only indication of deep, and possibly increasing, EU political togetherness in recent years. The fairly united front presented by 27 EU member states in the Brexit negotiation is another example. So is the fact that following the 2014 EU parliamentary election, and against many observers' anticipations, EU leaders followed an interpretation of the Lisbon Treaty that committed them to accept the 'lead candidate' of the political grouping that collected the most votes – in this case the European People's Party's Jean-Claude Juncker – as president-elect of the European Commission. At a more symbolic level, the twelve-starred European flag has acquired unprecedented visibility in the public life of several member states, for example in the national election campaigns in Austria and France in 2016 and 2017 (and, somewhat ironically, also in the UK in protests against Brexit after the referendum). More poignantly, the 'Euromaidan' revolution in Ukraine in early 2014 saw the European flag featuring prominently in a major national upheaval, illustrating the continuing political attractiveness of the European Union in its immediate neighbourhood[8].

On a more institutional level, the EU order has also been resilient against multiple challenges. The ECB has withstood successive lawsuits, mostly originating in Germany, that have questioned the scope of its policies. In this process, the German Constitutional Court has acknowledged the authority of the European Court of Justice in an unprecedented manner[9]. The European Commission's enforcement of state aid control in the banking sector has been made more authoritative by the 2013 Banking Communication. The SSM and SRM, even though their geographical scope of authority is currently limited to the euro area[10], constitute unprecedented cases of sector-specific supranational oversight in areas that were long seen as unquestionably falling under national sovereignty[11].

Thus, and in spite of the Brexit vote setback, the European Union is assuming an increasing number of features of a political entity, even as sovereignty still resides at the national level under the existing EU legal order and in the predominant perception of the European public.

Possible next steps: an agenda to strengthen the fourfold union

As the previous section's stylised analysis illustrates, the fourfold union is a work in progress. It is not realistic to imagine it being fully completed in the foreseeable future. As with any federal construct, the European integration process inherently produces hybrid systems in which different levels of governance are entangled. With this in mind, the current state of the fourfold union is still unsatisfactory when measured against the stated goal at the start of the process five years ago, namely the *"imperative to break the vicious circle between banks and sovereigns".* Reaching that goal should be the guiding objective of European leaders in their next steps of decision-making.

The 2018 opportunity

In several ways, the coming 12-18 months represent an exceptional opportunity for European reform. Brexit is a complex negotiation but no longer a systemic risk for the EU27 countries

8 Whereas there have been examples of political use of the European flag in other neighbourhood countries including Belarus, Georgia and Serbia, since the early 2000s, the Euromaidan was arguably the most iconic such case.

9 See eg Euractiv, 'Top German court refers ECB bond-buying case to EU judges', 11 February 2014, available at http://www.euractiv.com/section/euro-finance/news/top-german-court-refers-ecb-bond-buying-case-to-eu-judges/.

10 Non-euro member states of the European Union may voluntary join the banking union through a process known as close cooperation. None has so far done so, but Denmark and Sweden indicated in July 2017 that they might consider such a decision in 2019.

11 ESMA also has direct EEA-wide supervisory authority, but only over limited market segments, namely credit rating agencies and trade repositories. (Note: as mentioned in the disclaimer, the author is an independent board member of a trade repository supervised by ESMA).

that will remain in the union if and when the UK leaves. The two largest countries of the EU27, France and Germany, will enter this period with fresh government mandates following the 2017 election cycle[12]. For them and several other member states, the next significant political deadline is the European Parliament elections of 2019, which may focus public debates on the EU policy agenda.

This political context coincides with the end of the decade-long phase of widespread banking system fragility, as suggested in the previous section. This implies both that discussions about policy options need no longer be dominated by legacy issues, and that the euro area's present economic recovery is likely to remain robust for some time. Meanwhile, memories of the crisis are still vivid and may be enough to stop complacency from leading to inaction. A less than benign geopolitical environment might also incentivise the European Union to put its house in order.

Specifically, the view that the banking union would be initially a 'timber-framed' construction and that it would take more time to build a more solid 'steel-framed' version was memorably propounded by Germany's finance minister in a May 2013 article (Schäuble, 2013). The argument was that the arrangements for the banking union should initially be pragmatic and somewhat *ad hoc*, and that a later phase would make it possible to achieve *"our long-term goal: a truly European and supranational banking union, with strong, central authorities"*. Now that the legacy of the crisis is being convincingly addressed, with a number of remaining situations to handle but no systemic concerns, this vision can be used as a guide for the next phase of reform.

Of course, awkward political developments are still possible, and even probable, in the 12-18 months ahead. Several member states, of which Italy is the largest, will hold national elections, the outcomes of which are hard to predict. The tensions over the Catalan independence movement in Spain appear set to escalate, as do those about EU rule-of-law breaches in Hungary and Poland. Compared to the last ten years of intensive fire-fighting, however, these risks are comparably limited in scope.

The core bargain: from timber-framed to steel-framed banking union

As noted above, breaking the bank-sovereign vicious circle is the core purpose of the banking union project, but has not yet been achieved through the establishment of the SSM and SRM. The most direct bank-sovereign linkages are through national deposit insurance schemes and the high home bias in banks' sovereign exposures. The next phase of reform should address both of these issues simultaneously.

This would be aligned with the rhetorical emphasis promoted by the German government[13] of matching risk-sharing with risk-reduction, or perhaps more specifically, greater market discipline[14]. Regulatory curbs on banks' sovereign exposures would mitigate the bank-sovereign vicious circle in crisis situations, making it plausible that banks could survive a sovereign debt restructuring in their home country[15]. But the curbs would also result in significantly enhanced market discipline for the sovereign issuers themselves, since there would no longer be a presumption that domestic banks would act as buyers of last (or next-to-last) resort of their debt. In turn, the weakening of that link can be expected to reduce governments' incentives to insist on guarantees of the banks' uninsured liabilities. As a risk-sharing

12 Since France's election cycle is five years, and Germany's is four, this only happens once every twenty years.

13 See eg Francesco Guarascio 'Germany blocks small progress on banking union at EU summit,' Reuters, 16 December 2016, available at http://www.reuters.com/article/us-eu-banks-regulations/germany-blocks-small-progress-on-banking-union-at-eu-summit-idUSKBN1442Z8.

14 The distinction is more semantic and rhetorical than substantial. An emphasis on market discipline signals a more explicitly forward-looking approach than risk reduction, since risk reduction has already been achieved with the now well advanced (though belated) handling of legacy issues in the euro-area banking system.

15 A highly stylised proposal for such curbs is in Véron (2016b). The author is working on a more detailed blueprint, forthcoming in October or November 2017.

complement to the sovereign exposure curbs legislation, the transfer from the national to the European level of the explicit insurance of covered deposits would eliminate the most direct channel of bank-to-sovereign contagion.

As for the latter, the European Commission in November 2015 published a well-designed legislative proposal for a European Deposit Insurance Scheme (EDIS), with a decade-long transition towards a fully European framework divided into two phases of re-insurance and co-insurance respectively. But no comparably detailed proposal has been made so far on sovereign exposure curbs. This gap should be addressed as soon as possible for an appropriate debate in preparation for a balanced policy package to be endorsed at the political level during 2018[16].

No detailed proposal has been made so far on sovereign exposure curbs. This gap should be addressed as soon as possible

Sovereign exposure curbs and EDIS would form the core of the bargain, but additional initiatives are desirable. On the market-discipline side, several steps should be taken:

- The European Commission should tighten its state aid control framework by going further in the direction of senior debt bail-in than in the currently applicable Banking Communication of 2013;
- The SRB should be made responsible not only for decisions on resolution schemes, as is already the case, but also for their execution, which is currently left to national authorities;
- All banks in the banking union should be required to use International Financial Standards (IFRS) to achieve better accounting transparency and comparability;
- An effort should be made to harmonise bank insolvency law, with the long-term aim of an eventual single bank insolvency regime for the entire banking union area[17].

On the risk-sharing side, the ESM should be explicitly mandated to provide a backstop to both the SRF and the joint Deposit Insurance Fund that would be created as part of EDIS. The Direct Recapitalisation Guideline (ESM, 2014) should also be amended to allow the ESM to participate in precautionary recapitalisations (as defined in Article 32 of the BRRD), which would mitigate that specific bank-sovereign linkage and also instil better financial discipline into such recapitalisation processes.

Importantly, none of these measures requires a treaty change. They would be adopted as EU internal market legislation (ie with qualified-majority voting in the Council), or through decisions of the European Commission and the ESM respectively for the changes to the Banking Communication and to the Direct Recapitalisation Guideline. In this respect, the build-up of a steel-framed banking union would actually be easier than was envisaged by Mr Schäuble (2013), in which he took the view that treaty change would be needed to eventually deliver on his long-term vision.

Complementary reforms under the fourfold vision

Because the bank-sovereign vicious circle was the greatest fragility of EMU revealed during the ten years of crisis, addressing it as suggested above should take priority in the EMU reform agenda. But as the assessment in the previous section suggests, it is far from the only area where reform is evidently needed.

For the financial union, a necessary next step would be the reform of the governance and funding of ESMA to transform it into an independent, authoritative and well-resourced supervisor. This would then pave the way for an expansion of its supervisory authority to markets segments and matters of conduct of business, which are currently in the remit of national

16 This proposed approach differs from the one signalled by the European Commission in a recent Reflection Paper in which the recommendation is to decide on EDIS first, and on sovereign exposures at a later stage (European Commission, 2017).

17 A legislative proposal to harmonize some aspects of the hierarchy of claims on failing banks, published by the European Commission in November 2016 and currently under consideration by the EU co-legislators, can be viewed as an initial step towards that aim.

authorities. Such a reform would in turn powerfully contribute to integration and convergence in the capital markets area and thus to the European Commission's goal of a capital markets union as a necessary complement to banking union (see eg Constâncio, 2017).

For the fiscal union, the introduction of sovereign exposure curbs would, as mentioned above, significantly strengthen market discipline for sovereign issuers and thus create powerful incentives for fiscal discipline. Also in order to improve market discipline, a proper accounting and auditing framework should be introduced for sovereigns in the euro area, ie the standards under which government and national accounts are prepared should be further harmonised, and most importantly, the European institutions should be more directly involved in their review and possibly also their preparation. The size of the ESM should also be increased so that it can more credibly face crisis scenarios involving the larger euro-area countries. As a counterpart to the increased market discipline, a reform of the existing framework based on EU-level administrative disciplines could be envisaged in order to reduce the gap between its stated purpose and its limited enforceability, which was revealed by the recent episodes.

For the economic union, the early success of the SSM and SRM should be used as a proof of concept for the development of European agencies with direct supervisory and enforcement authority in other sectors in which the national implementation of even harmonised rules contributes to cross-border market fragmentation. This is the case in a significant number of regulated services sectors, including electricity and gas transport and distribution, rail transport and, increasingly crucially, digital services in matters of privacy and data protection. For decades, the received wisdom in the European Union, including for financial services, was that supranational supervision and enforcement was desirable but politically impossible. Now that the banking union has demonstrated that it can work in practice as well as in theory, this insight could form the basis for a significant push forwards for the EU single market. Simultaneously, an EU-level legislative framework for the security review of foreign direct investment should be introduced, even if in the immediate future the actual assessments continue to be predominantly made at the national level[18].

As for politics and institutions, public accountability of EU agencies and the scrutiny of the European Parliament should be enhanced. For example, in a reform of the governance of ESMA, a more compact board of, say, five to seven members should be created to replace the current unwieldy and intergovernmental Supervisory Board, and its members should be vetted by the European Parliament, as is the case for the SRB's full-time board members and for the chair and vice chair of the SSM Supervisory Board. On a different level and to strengthen the legitimacy and credibility of EU institutions, France and the other member states should renounce the European Parliament seat in Strasbourg and accept Brussels as the single venue for that institution, thus putting an end to the monthly migration that unnecessarily exposes the EU democratic process to the charge of wastefulness.

Most significant in the near term for 'political union', however, will be the 2019 European Parliament elections, as this will be the first time that the vote will be explicitly and (presumably) unquestionably framed by the 'lead candidate' system introduced under the Lisbon Treaty, and thus a vote for the quasi-executive function of European Commission president. How much cross-border political mobilisation results from this new system will be important, not only for the perception and role of the European Parliament and Commission, but also more generally for the evolving debate about the democratic drivers of EU policymaking.

More ambition for fiscal union?

The point on the 2019 European Parliament elections hints at why the above recommendations might appear somewhat unambitious in the area of fiscal union, compared with widely publicised recent suggestions of European safe bonds, a euro-area fiscal capacity or budget, a

18 An argument and blueprint for such a framework was proposed in Röller and Véron (2008) and remains relevant.

European Monetary Fund and/or a euro-area finance minister. The underlying analysis is that the euro area and European Union are politically prepared for the suggested steps combining risk sharing and market discipline, and thus for the shift from the present 'timber-framed' to a 'steel-framed' banking union, but that the same might not be true when it comes to the ability to tax and spend, or fiscal sovereignty.

This assessment might underestimate the readiness of the European body politic for a major step towards fiscal integration. Even so, it appears prudent to reserve the political window of opportunity of 2018 for projects that have a reasonably high likelihood of practical feasibility. If the 2019 European Parliament election results signal a limited, or perhaps even declining, commitment of the European public to EU integration, such prudence will have been vindicated. If, on the other hand, the election outcome suggests a greater appetite than is now generally perceived for joint steps towards greater togetherness, then it will be time to consider bolder reforms of the fiscal framework.

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