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The European Banking Union: Whence? Whither?

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Is the Maastricht design viable?

The euro at a crossroads

Is the Maastricht design viable?

- No! The euro 1.0 is not viable (EU Council, June 2012)
- Maastricht's choice:
  - Single currency
  - Some fiscal policy coordination (SGP)
  - Absence of economic policy coordination
  - Reliance on market discipline
- This choice amounts to:
  - A minimum loss of national sovereignty
  - No elements of insurance/shock absorption
- The fault lines of the Maastricht approach, combined with policy mistakes, were exposed by the sovereign crisis:
  - Lack of credible crisis prevention/resolution mechanisms
  - Strong political resistance to move forward (until late 2011)

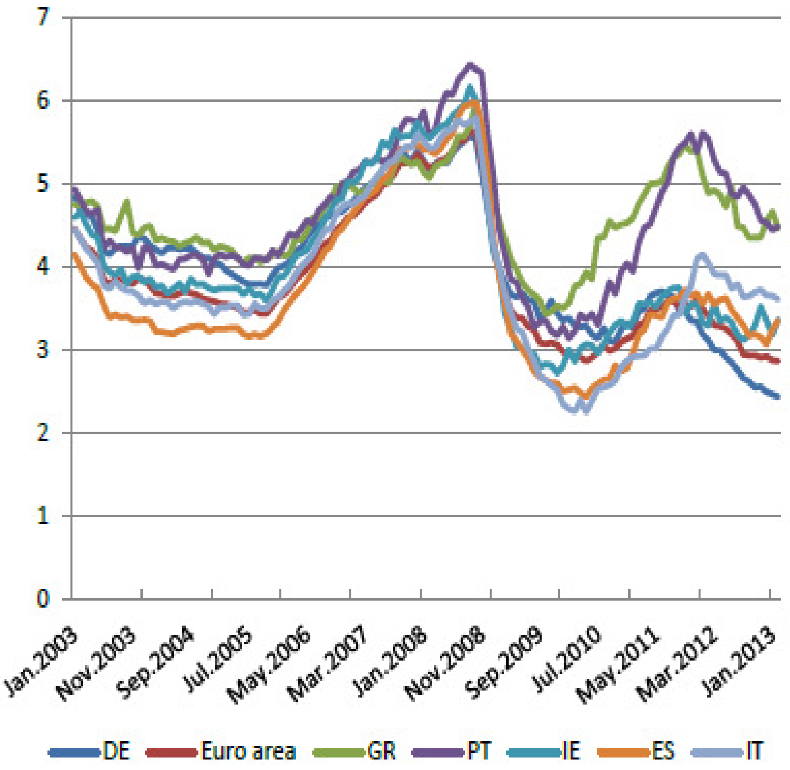
Is the Maastricht design viable?

- **The absence of fiscal and financial shock absorbers has led to the emergence of two phenomena which are inconsistent with a smoothly functioning monetary union:**
    1. **Solvent sovereigns lose access to a risk-free liquid asset**
    2. **Solvent financial/non-financial companies lose access to cross-border funding**
- **Visible consequences:**
    1. **Investors' strike ("sudden stops")**
    2. **Breakdown of the monetary policy transmission mechanism**

Is the Maastricht design viable?

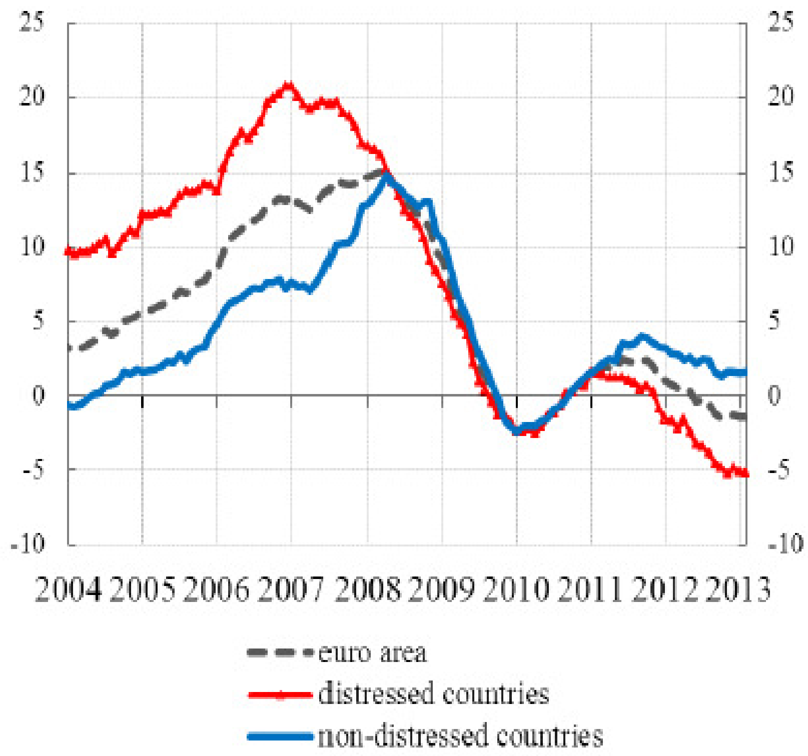
Single monetary policy?

MFI interest rates (composite rate to households for house purchase and non-financial corporations)
(non-weighted, percentages)



Source: ECB.

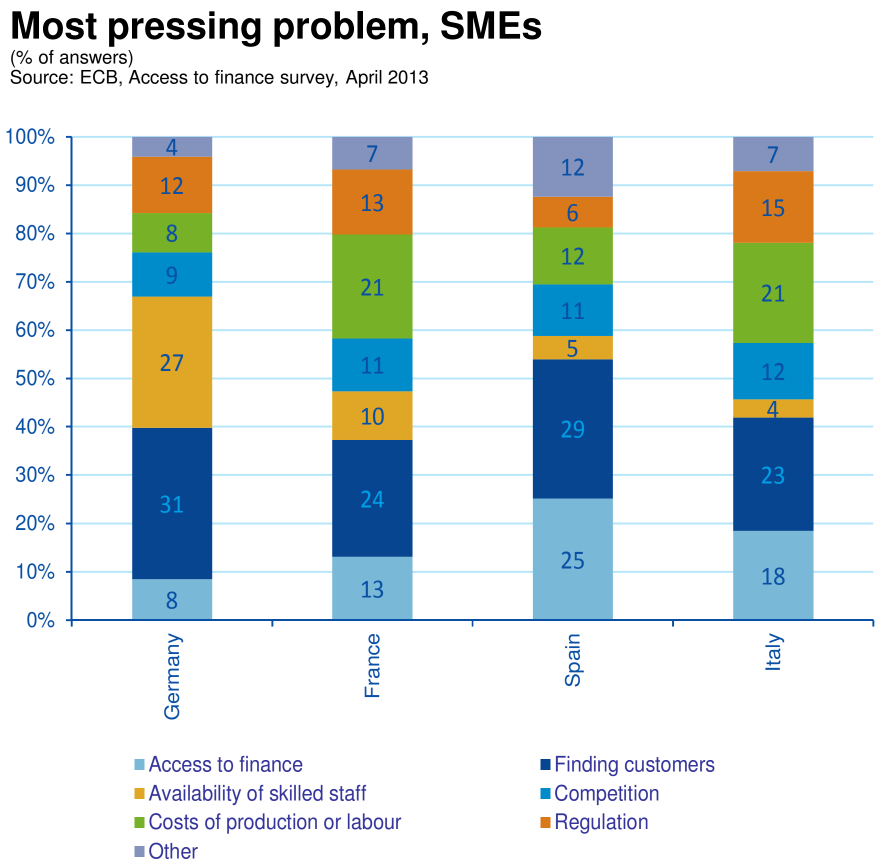
MFI loans to non-financial corporations
(annual loan growth; percentages)



Source: ECB.

Is the Maastricht design viable?

Financial fragmentation and SME financing



SMEs in peripheral countries are more concerned about access to funding

There are demand and supply factors behind the scarcity of new credit in peripheral countries

Is this a permanent competitive disadvantage?

Fragmentation is incompatible with the euro

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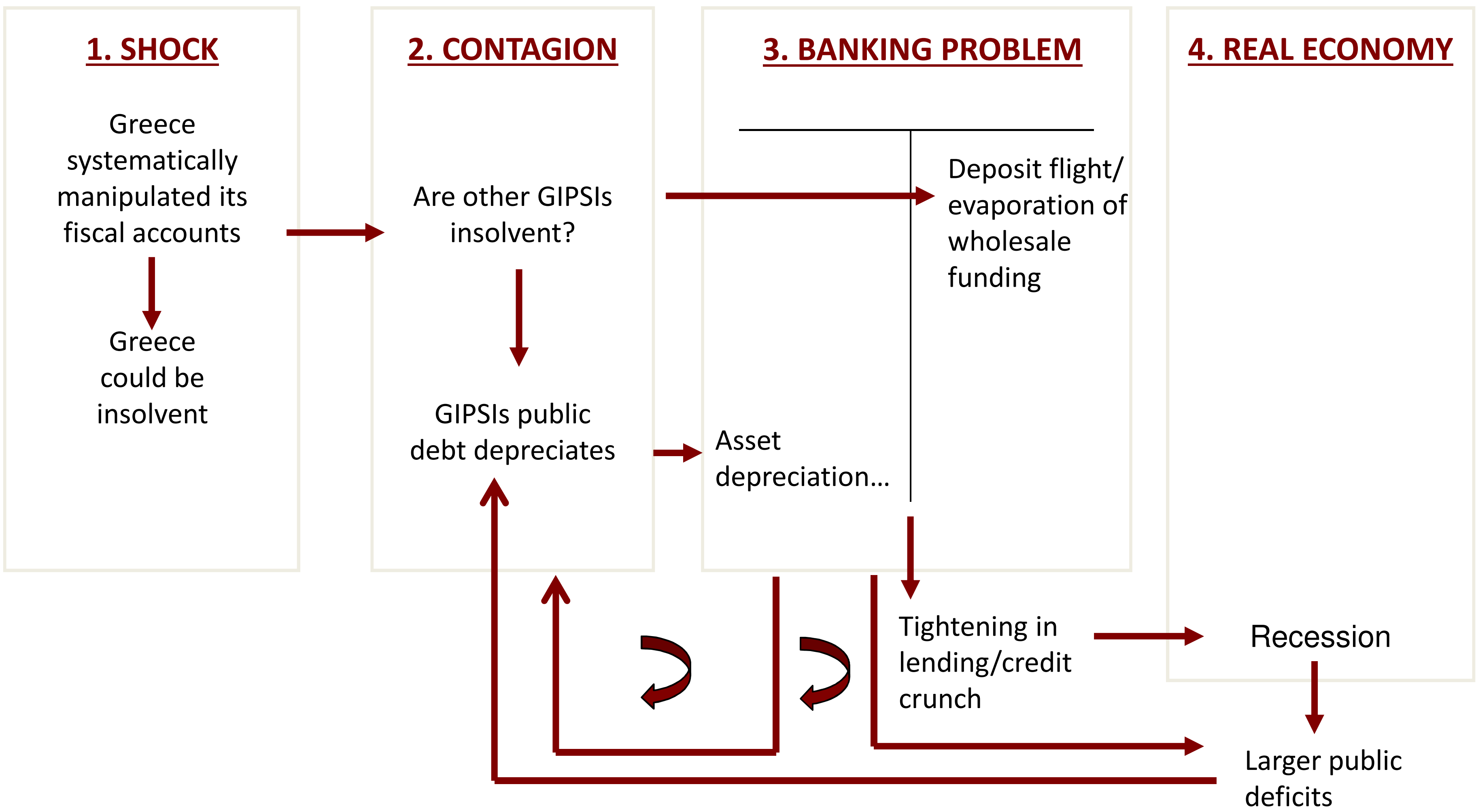
- **Visible consequences:**
  1. **Investors' strike ("sudden stops")**
  2. **Breakdown of the monetary policy transmission mechanism**
  3. **Socio-political tensions (credit crunch and fiscal adjustment)**
  4. **Emergence of "redenomination risk", ie, euro break-up risk**
- **Lacking significant progress towards more integration, the ECB can offer only temporary relief**
- **The "diabolic loops" of the sovereign debt crisis are unstoppable, unless a banking union is created**

Why do we need a banking union?

The sovereign debt crisis and the "diabolic loops"



Why do we need a banking union?

- **The absence of a deep and irreversible degree of financial integration threatens the very essence of the single currency: the *fungibility of money***
- **A banking union for the *euro 2.0*:**
    1. **Single rulebook**
    2. **Single supervisory mechanism**
    3. **Central banking resolution authory/fund**
    4. **Integrated system of deposit guarantee funds**

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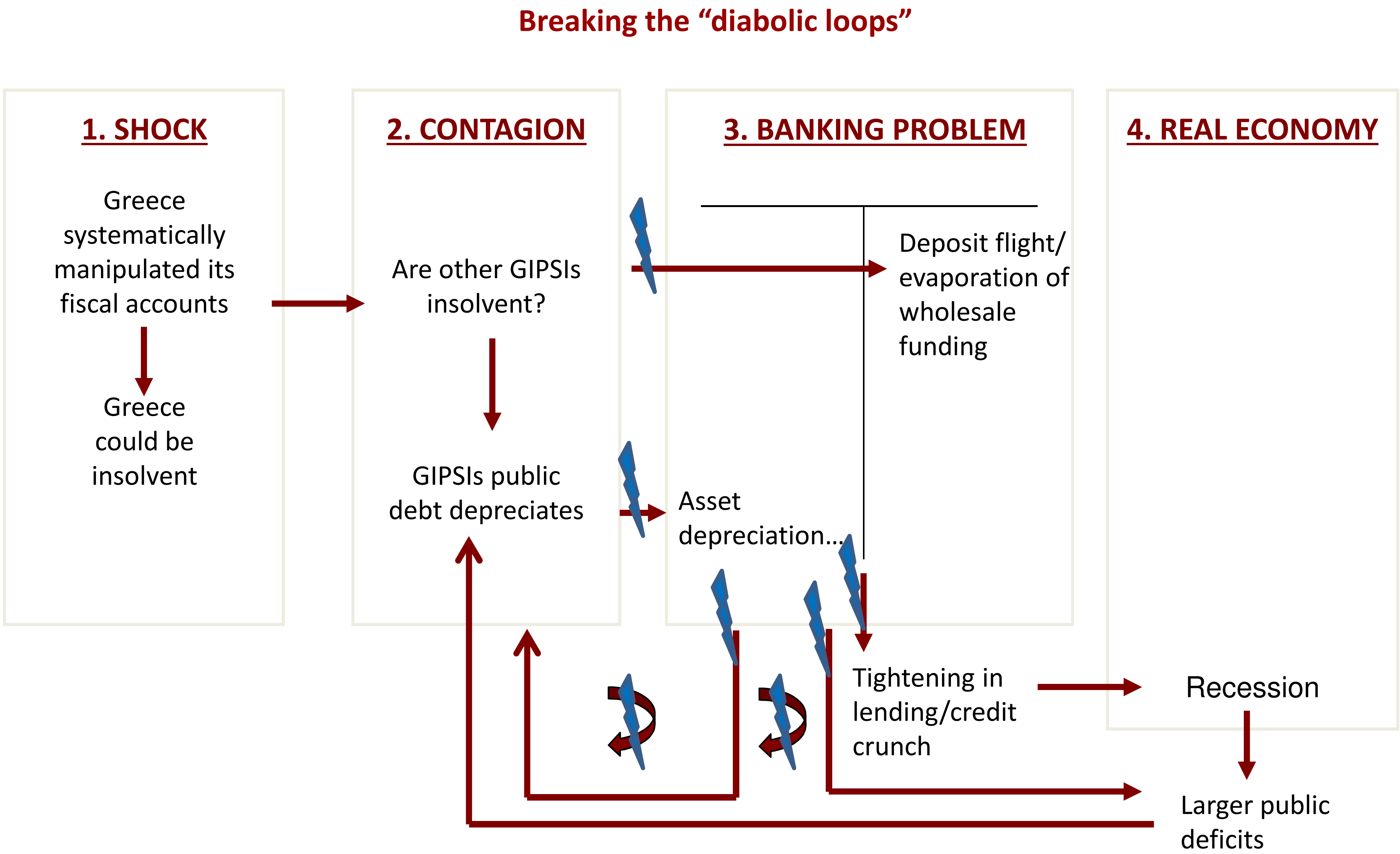
- **What could be achieved?:**
  1. **Breaking the banks-sovereigns negative feedback loops**
  2. **Restoring a single monetary policy**
  3. **Supressing national supervisory biases**
  4. **Minimizing taxpayers burden**

Why do we need a banking union?



Banking union: Progress and risks

Single rulebook (UE 27)

- CRDIV: March
- RRD & DGS: June

Single Supervisor (EZ)

- ECB direct supervision of ≈ 130 banks since mid 2014
- Right to intervene at any time

Single Resolution (EZ)

- ESM recapitalization (operative framework): June
- COM proposal on SRM: June 2013
- No decision on single/multiple authority

Single DGF (EZ)

- No details

2013	2013-2014	2014-2015	?

TRANSITION

Risk of centralized supervision, decentralized resolution and persistence of the sovereign-banking vicious circle

What are the fiscal and the political implications?

- **Deep implications for the stability of the eurozone**
- ***Scenario 1*: BU+status quo: ESM+fiscal compact+ECB as a lender of last resort to the banks and the markets**
- ***Scenario 2*: Mantaining assured market access at all times may require, in addition:**
  1. **Dealing with the legacy from the past: Debt Redemption Fund**
  2. **Mutualizing short term debt: Eurobills**
- ***Scenario 3*: Eurozone budget, eurobonds, eurozone finance minister…**
- **Legitimacy and accountability: A two-stage process?**
  1. **As much progress as possible within current Treaty**
  2. **Treaty changes in the medium term**

Whither the euro and the banking union?

How should the euro area be when the banking union is in place?, where are we heading to?

Towards a Europe more integrated from a monetary, banking, fiscal and political points of view. This process will provide stability and will enable a more efficient resources allocation

There will be bigger and cross-country financial entities, both wholesale and retail. There is a risk of lower competition as there will be less entities, so more integration is needed (single European market)

There is not a plan B for the banking union, as the alternative is the break up of the euro