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NICOLAS VRON, AUGUST 2012

THE EURO AREA HAS MANY PROBLEMS but the core of the current crisis, what makes it unique, is Europe's insufficient ability to make authoritative policy and political decisions for the region as a whole. To correct this weakness, Europe must build a fourfold union that would allow such executive decisions to be made. The four components are: (1) a banking union, (2) a fiscal union, (3) a competitiveness union, and (4) a political union, ie institutional reform to embed democratic accountability more solidly in decision-making.

The key issues for the euro area in this respect are:

- The deterioration of credit conditions in the euro area stems less from inadequate decisions than from an absence of decisions when they were needed. This 'executive deficit' is partly a consequence of the European institutions' lack of democratic accountability, often referred to as democratic deficit. It also contributes to a loss of European citizens' trust in those same institutions. The European Central Bank (ECB) is a partial exception to this problem but cannot make up for the lack of decisiveness of the other institutions.

- Accordingly, profound changes must be made to Europe's institutional framework to make it effective in resolving the current crisis and preventing future crises. An authoritative European-level executive framework must oversee banking, fiscal and structural policies. This executive framework must be made accountable to Europe's citizens, and for this the European Parliament must become more representative and exert better control over policymaking. Those four components of banking, fiscal, competitiveness and political union will take several years to be completed. They are mutually interdependent and must be taken together, ideally in parallel increments. In particular, the completion of a banking union relies on federal deposit insurance which itself requires a credible supranational fiscal backstop. And without the democratic accountability provided by political union, no new integrated policy framework can be sustainable.

- Europe must also overcome its tendency to jump to permanent solutions, and acknowledge the need for pragmatic short-term actions that are tailored to the urgency of the crisis. Europeans have repeatedly tried to resolve long-term issues before deciding on short-term fixes, but that strategy is a luxury they no longer have. Specifically regarding banking issues, a proper crisis management and resolution system must be put in place before all longer-term institutional questions are answered.

- Thus, leaders should establish a temporary euro area bank resolution authority, as none of the existing institutions has the skills and mandate that would allow it to perform the thankless task of identifying and restructuring failing financial institutions. A successful bank crisis resolution process will require temporary guarantees, including temporary central reinsurance of national deposit insurance systems by the soon-to-be-created European Stability Mechanism (ESM) or by a more robust future central financial instrument.

- In the longer term, the euro area needs not only a single supervisory mechanism for banks but also a regionally based deposit insurance system and a central resolution authority for failing banks. The ECB can play a large role in this future framework but cannot be its only component. National bank supervisors will retain many of their attributes but their governance will need to change. Ultimately the banking union should cover all banks in the euro area and possibly in other European Union member states, even though it seems likely that exceptions will be initially negotiated by member states to exclude some smaller banks from its oversight.

A breakup of the euro area would be disastrous for Europeans and to a large extent for the global economy. The choices facing Europe's leaders and citizens are daunting. Their slow pace of decision-making has exacted a heavy price from Europe's economies, societies, and families. Greece remains a burning concern. No one can be assured that the euro area would survive its disorderly exit, but there is still no clear enforcement framework available if its adjustment trajectory keeps veering off track, as it has repeatedly over the last two years. Investors have good reasons to be nervous.

Yet it is not too late for Europeans to take action to ensure the survival, sustainability and success of monetary and economic union.

The remainder of this Policy Contribution expands on these points and provides additional analysis.

EUROPE'S EXECUTIVE AND DEMOCRATIC DEFICIT

Europe's systemic financial crisis has been going on for five years. Its start can be dated back to German top banking supervisor Jochen Sanio's reported warning on 29 July 2007 of "the worst banking crisis since 1931" while discussing the public bail-out of a medium-sized lender, IKB[1]. Since then, European banking policymakers have been in continuous crisis management mode but have never been able to bring the interbank market back to its normal state without exceptional government guarantees. As is well known, from late 2009 the banking fragility was compounded in the euro area by the growing unwillingness of market investors to lend to sovereigns, first Greece and later others, creating a mutually reinforcing 'doom loop' between weak sovereign and banking credit conditions.

Half a decade is a long time in policymaking. In retrospect, the lack of proactive decision-making at the European level is striking. While the common depiction is of a crisis of the euro-area periphery, it can equally be described as a failure of the euro-area centre, by which I mean the mechanisms and actors that determine executive policy for the entire euro area as opposed to individual member states. Prominent among these are the European Commission, European Council of EU member states' heads of state and government, Economic and finance affairs (ECOFIN) council of EU member states' finance ministers, Eurogroup meeting of euro area member states' finance ministers, plus multiple ad-hoc subsets of euro area countries and institutions, such as French-German and more recently French-German-Italian or French-German-Italian-Spanish meetings, the 'Frankfurt Group' in late 2011[2], or the four remaining euro area triple-A rated countries in early 2012[3]. There have been occasional misguided decisions, such as an ill-designed bank recapitalisation plan adopted in late October 2011[4]. But, on the whole, such policy errors of commission have been less damaging than the absence of decisions.

European institutions have long been criticised for their democratic deficit, and the crisis has revealed an equally gaping executive deficit. Moreover, these two feed each other: the lack of democratic legitimacy contributes to the paralysis of executive decision-making; and Europe's inability to solve its collective problems deepens citizens' distrust of its institutions. This is another kind of 'doom loop', political rather than financial, but no less damaging than the one between sovereign and banking credit. To be fair to the personalities involved, this failure must be seen as a systemic problem of inadequate incentives and institutions, rather than a shortcoming of individual leadership.

The insufficiently democratic nature of European decision-making has many aspects. First, European citizens lack equal representation in the

1. Financial Times, 'Germany rescues subprime lender', 2 August 2007.

2. This informal group included, in alphabetical order: European Commission President José Manuel Barroso; European Central Bank President Mario Draghi; Eurogroup Chairman Jean-Claude Juncker; International Monetary Fund Managing Director Christine Lagarde; German Chancellor Angela Merkel; European Commissioner Olli Rehn; French President Nicolas Sarkozy; and European Council President Herman Van Rompuy. See for example Peter Spiegel, 'EU presses Rome and Athens', Financial Times, 14 November 2011.

3. Finance ministers of Finland, Germany, Luxembourg, and the Netherlands held joint meetings in the context of the Greek debt restructuring negotiations. See for example Associated Press 'Greek debt talks to stretch into weekend', 3 February 2012.

4. See for example Nicolas Véron, 'Banking federalism is key to the Eurozone's survival', Emerging Markets G20 Edition, 3 November 2011.

'EU institutions have been criticised for their democratic deficit; the crisis has revealed an equally gaping executive deficit. The lack of legitimacy contributes to the paralysis of executive decision-making; and Europe's inability to solve its problems deepens citizens' distrust.'

5. Press release No.

13. Euro Area Summit Statement, Brussels, 29 June 2012

14. In my case, relevant references include 'Is Europe ready for a major banking crisis?' *Policy Brief* 2007/03, Bruegel, August 2007; 'A solution for Europe's banking problem', with Adam Posen, *Policy Brief* 2009/03, Bruegel, June 2009; prepared statement on 'The European Debt and Financial Crisis: Origins, Options and Implications for the US and Global Economy', US Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Security and International Trade and Finance, hearing on 22 September 2011.

15. See in particular Dominique Strauss-Kahn, 'Crisis Management Arrangements for a European Banking System', keynote speech at the European Commission conference *Building a Crisis Management Framework for the Internal Market*, Brussels, 19 March 2010.

16. European Commission press release IP/12/570, 'New crisis management measures to avoid future bank bail-outs', 6 June 2012.

ESM "to recapitalise banks directly. This would rely on appropriate conditionality [for each relevant member state], including compliance with state aid rules, which should be institution-specific,

19. Transcript of the President of the French Republic's press conference in Brussels, 23 May 2012, available in French on http://www.elysee.fr/president/les-actualites/conferences-de-presse/2012/conference-de-presse-de-m-le-president-de-la.13289.html.

20. Reuters, 'Merkel calls for body to supervise major EU banks', 4 June 2012.

21. For a discussion of this contrast see Morris Goldstein and Nicolas Véron, 'Too Big to Fail: The Transatlantic Debate', in J.F. Kirkegaard, N. Véron and G.B. Wolff (eds), *Transatlantic Economic Challenges in an Era of Growing Multipolarity*, Peterson Institute/Bruegel Special Report, 22 July 2012.

22. Interview with Mario Draghi in *Le Monde*, 21 July 2012.

23. Gabriele Steinhauser and Brian Blackstone, 'Europe's Bank Shifts View on Bond Losses', *Wall Street Journal*, 16 July 2012.

including the US Resolution Trust Corporation (1989-95), the Swedish Bank Support Authority (1993-96), or, in the case of systemic issues beyond the financial system, the Treuhandanstalt that restructured and sold the former German Democratic Republic's state-owned enterprises in 1990-94, or the US Presidential Task Force on the Auto Industry that coordinated government policy on Chrysler and GM in 2009. While none of these experiences passed completely smoothly, they all suggest that a temporary, well-empowered task force structure, obviously with adequate provisions for accountability and transparency, would represent a credible and well-suited response to the short-term challenge of European bank crisis resolution.

This leaves open the question of future ownership of those institutions that the temporary resolution authority would find insolvent following in-depth balance sheet assessment. In legal terms, those countries that do not currently have a special resolution regime for banks should pass emergency legislation to create one, and those that have one might also need emergency legislation to empower the temporary resolution authority at the euro-area level. Failed banks will generally need to be taken over by public authorities, but there might be no uniform framework by which public authorities will become equity owners. One can imagine a combination of national government ownership and ownership at the European level (specifically by the ESM as suggested by the euro area summit statement of June 29), depending on countries and individual bank situations. This should logically be negotiated by the temporary resolution authority together with the imposition of losses on relevant categories of creditors (excluding, of course, those which are covered by explicit guarantees). While these negotiations should be conducted with a sense of impartiality and evenhandedness across the euro area, differences in legal environments, banking structures and fiscal positions make it unadvisable, and arguably impossible, to adopt a one-size-fits-all approach.

Beyond this, crisis resolution and restructuring will necessarily involve significant financial risk-taking by public authorities – but these have to be compared to the current open-ended explicit and implicit commitments of support to the financial sector that exist at the level of individual member states. Here again, banking policy cannot be considered in isolation from the other components of fourfold union.

This is most obvious as regards the protection of retail deposits, and more generally the prevention of further capital flight, particularly in the more fragile countries. As previously argued, European policymakers should refrain from a blanket and permanent guarantee of all bank liabilities, but antees until the completion of a credible, system-wide process of bank assessment as previously described.

Finally on the sequencing, several successive steps will be needed and policymakers should preserve as much flexibility as possible in their intervention framework. Even under the most optimistic assumptions, it would take at least 2-3 months to build a temporary European resolution authority; 3-4 more months to reach a comprehensive system-wide assessment of the balance sheet and capital positions of the most important banks (which would represent a sample comparable to that of the 2011 stress tests, say between 60 and 90 banks); and one or two additional months to negotiate the outline of restructuring packages for those banks found insolvent, which might number in the double rather than single digits. As a consequence, the disclosure of capital assessments, which can only be made once adequate backstop plans have been defined for failed executive and problematic democratic accountability, which advises against delegating excessive discretionary power to the ECB. The ECB itself has signaled that it had no appetite to assume the inherently controversial task of bank resolution, including by stressing that the future banking union framework should allow the ECB to act "without risks to its reputation".[25] Thus, it appears inevitable that the long-term framework will include a European resolution authority separate from the ECB, and also most likely separate from all other currently existing institutions for the reasons developed in the previous section. However, it is desirable that the resolution authority should be able to have close interaction with the ECB, particularly in times of crisis. For this reason it should preferably be located in Frankfurt, as geographical proximity would help in this respect even as the two institutions would remain separate.

The supervisory function has synergies both with the lender-of-last-resort role of the ECB, and with resolution authority. If the June 29 decision is to be implemented, the ECB will develop supervisory functions of its own in any case. It is likely that the resolution authority will require a supervisory mandate as well, as is the case with the Federal Deposit Insurance Corporation (FDIC) in the United States[26]; as in the US, it could be coupled with the deposit insurance function, even though a formally separate deposit insurance fund could be envisaged as well. Some overlapping of supervisory functions across two or more European institutions should of course be kept to a minimum to avoid duplication of some costs and complexity, but its existence should not necessarily be seen as a problem in itself: situations of overlap exist in several jurisdictions including the United States (Federal Reserve/FDIC/Office of the Comptroller of the Currency) but also Japan (Bank of Japan/Financial Services Agency) and Germany (Bundesbank/BAFin). If the euro area is to avoid such overlap, its leaders may need to envisage a global level, and D-SIFIs as those that are systemically important at the domestic level). It should also cover smaller banks, even though most operational duties related to these could and should be devolved to national supervisors. This would also help maintain, or rather establish, a competitive level playing field across the banking union. It is likely however that some member states will try, at least in a first phase, to negotiate exceptions for sections of their respective banking systems with particularly strong links with local and regional environments. Such exceptions from the general framework of banking union, which would also encompass separate deposit insurance systems, appear unadvisable from the standpoint of policy consistency and effectiveness, but may be inevitable to reach a political consensus at least in an initial phase. They may concern the German *Sparkassen-Finanzgruppe*, with the possible exception of the *Landesbanken* within it, and perhaps also Germany's cooperative bank system (*Volksbanks* and *Raiffeisenbanks*, and DZ-Bank). Whether other exceptions will be sought by member states other than Germany remains to be seen.

In terms of geographical scope, the generally adopted working assumption is that the banking union would be identical in perimeter to the euro area. However, it can also be envisaged that its perimeter would be wider and include some EU member states that may not join the euro area in the short term, say Poland or Denmark. This would create additional complexity and potential risks, but it is technically conceivable and may be sta-

This brief and incomplete enumeration shows that many different parameters remain to be discussed in order to put in place a consistent permanent institutional framework for the future banking union. In this context, it is to be hoped that pragmatism will prevail and that direct financial intervention by the ESM in individual banks will be unlocked before all these parameters are set, in order to allow swift and effective crisis management and resolution. However, it is also desirable that euro-area leaders achieve consistency between their short-term and long-term planning, and that an early version of a future European supervisor can be set up rapidly and provide continuity of approach beyond the short-term phase and beyond the possible lifetime of a temporary resolution authority, if such an option is indeed chosen.

OUTLOOK

Even under optimistic assumptions, the situation in the euro area will remain affected by high levels of market volatility. Many observers and investors have gradually lost hope in the euro area's ability to resolve its problems. They are not encouraged by what they perceive as a state of denial affecting several senior European policymakers, about both the severity of the region's problems and the need to maintain or regain investors' trust to resolve them. In their narrative, the euro area is too diverse to survive as a monetary union, and centrifugal forces are too strong to be contained.

I share the view that Europe's current institutions are not strong enough to contain such forces indefinitely, but the European Union is and remains a work in progress and is capable of change. The completion of a fourfold union would create a much more robust and resilient framework that could enable decisions to repair investors' trust and keep centrifugal forces in check. Arguments that Europe is too diverse for stronger central institutions to exist do not hold up to scrutiny. India is one example of a fairly stable democratic polity whose internal historical, social,

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economic, religious, ethnic and linguistic diversity is greater than in the European Union, let alone the euro area. Among more advanced economies, Canada and Switzerland are other examples of stable, yet diverse and multilingual democracies. Many pessimistic observers underestimate the extent to which well-designed political institutions can tie different communities, provided there is a desire to hold together.

European integration has been a process of political innovation from the start. There is no precedent, and still no equivalent elsewhere in the world, for the kind of supranational institution-building that has been going on in Europe since 1950. Even though parallels might be drawn with some cases of constitution of federations, particularly the United States in the 1780s and Canada in the 1860s, these cases are too different from Europe to have any predictive relevance. As with all innovation, success can neither be taken as given nor considered impossible.

In the specific case of the euro area, powerful 'de facto solidarities' exist and make the bloc more resilient than superficial observation might suggest. These solidarities are of a different nature from those involved in earlier steps of European integration, and are often ill-understood including in the European economic policy and research community itself, as the noisy debate about so-called Target2 imbalances among Eurosystem central banks, among others, has illustrated[27]. They are particularly strong in the case of Germany, the euro area's pivotal member state.

Nonetheless, Greece remains the litmus test of whether the euro area will hold together, and the outcome there is hard to predict. Euro-area leaders, including Greece's, might come to the conclusion that further transfer of economic sovereignty by Greece to the euro-area level is the only way to prevent a disorderly dislocation. If this happens, the issue of European institutions' democratic accountability, in other terms the political union agenda, will gain even more urgency than is currently the case. Similarly, if a legal impasse is reached as the consequence of future rulings of Germany's constitutional court about crisis management initiatives, a major strengthening of the democratic underpinnings of EU institutions might be the only way to overcome the court's reservations against more transfer of decision-making towards the supranational level.

There is no easy, simple or painless way to resolve the euro-area crisis successfully. An enormous effort of adjustment and transformation lies ahead, in addition to the substantial sacrifices already incurred by Europe's member states and citizens. Achieving a fourfold union as described here is indispensable to avoid a disorderly and disastrous euro-area breakup. Time and stamina will be needed. The changes involved are significant, but not impossible. The European Union does not have to become a 'superstate' to overcome the crisis, and will remain a hybrid in which component nation-states play an irreducible role. The fragmentation of Europe's financial, economic and social space that has occurred since the crisis started is damaging and worrying, but has not reached a point of no-return beyond which it could not be reversed. The euro area faces daunting challenges, but is far from condemned to failure.

27. See for example Isabelle Kaminska, '*That* Target2 presentation', *FT Alphaville*, 27 June 2012.