

Vítor Constâncio: Banking Union and European integration

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the OeNB Economics Conference, Vienna, 12 May 2014.

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Ladies and gentlemen,

I thank the Oesterreichische NationalBank for inviting me to Vienna to make this address on the Banking Union and European Integration at the occasion of one more of its prestigious Economic Conferences. As Vice-President of the ECB, I have been involved in the Banking Union project from the start and it is with great pleasure that I now see it beginning to come into place. By the start of next year, we will have an operational Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM). It is undoubtedly the more important and far reaching reform in the European Union since the creation of the euro.

As many other European institutional innovations, the project was born in connection with the crisis management effort of trying to sever the bank-sovereign nexus that was contributing to financial fragmentation. The idea of launching the SSM emerged during the June 2012 European Council meeting. It was a consequence of the decision that the ESM could directly recapitalise weak banks, thus taking some fiscal pressure off sovereigns. But if the European level were to assume liability for European banks, it also logically had to assume control: hence the need for a European supervisor. It was only later that the concept of a fully-fledged Banking Union emerged, which would contain a SRM and a possible Deposit Guarantee Scheme, which has meanwhile been postponed.

Rationale and objectives of Monetary Union

The absence of European supervision and resolution had however already been identified by many analysts as an initial design flaw of monetary union. As the crisis developed, this became clear. The high degree of interconnectedness, in the euro area in particular, implies that the impact of supervision affects not only the domestic banking sector but also, as an externality, other countries. This has been captured by the so-called “financial trilemma”. The concept of the trilemma illustrates the impossibility of achieving simultaneously three objectives in an environment with linked financial markets. These objectives are financial stability and financial integration while preserving supervision at national level.¹

The reasoning behind this is the following: with increasing financial integration, pursuing national financial policies will generally not lead to financial stability, because national policies seek to benefit national welfare, while not taking into account externalities of national supervisory practices in other countries.² This leads to an under-provision of financial stability as a public good.³ A correction of this flaw addresses the first objective of Banking Union.

A second objective for Banking Union⁴ stems from the evidence that keeping supervision at national level in both creditor and debtor countries contributed to the large imbalances that

¹ Schoenmaker, D. (2011): “The Financial Trilemma”, forthcoming in Economics Letters.

² Holthausen, C. and T. Ronde (2004): “Cooperation in international banking supervision”, ECB Working Paper 245.

³ On financial stability as a public good, see for instance Beck et al (2010): Bailing out the Banks: Reconciling Stability and Competition An analysis of state-supported schemes for financial institutions.

⁴ Banking union and the future of banking, *speech by Vítor Constâncio, Vice-President of the ECB, at the IIEA Conference on “The Future of Banking in Europe”, Dublin, 2 December 2013; Towards the Banking Union, speech by Vítor Constâncio, Vice-President of the ECB, at the 2nd FIN-FSA Conference on EU Regulation and Supervision “Banking and Supervision under Transformation” organised by the Financial Supervisory*

developed before the crisis. Without unified supervision, it was impossible to contain the build-up of such imbalances in the pre-crisis period. National supervisors had to respect the single market rules and lacked the macro-prudential tools to offset the effects of large capital inflows. As I have often underlined, private debt intermediated by the banks, more than public indebtedness, was at the heart of developments in peripheral countries.⁵ By introducing supervision at the European level, the Banking Union now offers a possibility to better pre-empt such developments in the future – and therefore to better protect the real economy and financial stability in the whole area.

A third objective of the Banking Union is the contribution it can provide to financial integration, by separating banks' robustness from sovereigns and consequently reduce markets' fragmentation.

The fourth objective is closely connected with the third one. Imperfect financial integration in a currency union directly complicates the task of the central bank. It becomes harder to achieve a smooth transmission channel of monetary policy and to ensure similar levels of interest rates across countries. Thus, the tendency towards less financial integration induced by both the financial crisis and institutional shortcomings has undesirable effects also for the conduct of monetary policy.

A final objective of Banking Union is to increase the efficiency of the banking system which is the dominant source of finance for the European economy. This will be achieved in different ways. First, the SSM will be a strong and independent supervisor, enforcing supervision consistently across the participating Member States. With supervision at a European level, the focus of supervisory activities will be aligned with the activities of cross-border banks and the area-wide financial sector, thus less subject to domestic considerations.

With a micro-prudential task and an extensive set of powers, the SSM should be able to monitor risks faced and stemming from individual banks in the system and address them in a timely fashion. This is supported by the macro-prudential task conferred to the ECB entailing the monitoring and addressing of risks from a system-wide perspective. The fact that the ECB has been given power over the direct application of macro-prudential instruments as well as a coordinating role among all member states, is an important innovation of the new Regulation that will improve financial stability in the euro area. Furthermore, the SSM will have a European focus and support the development and effective application of the single rulebook, the harmonisation of supervisory practices and procedures, creating a level playing field and reducing compliance costs. The SSM, coupled with the other elements of the Banking Union should be conducive to ensuring the most efficient allocation and transfer of intra-group capital and liquidity. Therefore, it should contribute to the creation of truly pan-European banks and enhance cross-border banking integration which will reduce transaction and compliance costs and bring efficiency gains.

On the other hand, the new framework may lead down the road to a period of consolidation in a not much concentrated European banking sector. In fact, there is scope for further consolidation without reinforcing the so-called "too-big-to-fail" problem and for reaping the benefits of efficiency-driven consolidation. The present weak profitability in the banking sector and the existence of over-capacity in certain areas of the European market suggest that some efficiency gains could be achieved.

Authority, Helsinki, 12 February 2013; Towards a European Banking Union, speech by Vítor Constâncio, Vice-President of the ECB, Lecture held at the start of the academic year of the Duisenberg School of Finance, Amsterdam, 7 September 2012 (ECB website).

⁵ See "The European Crisis and the role of the financial system", *speech by Vítor Constâncio, Vice-President of the ECB, at the Bank of Greece conference on "The crisis in the euro area" Athens, 23 May 2013 (ECB website).*

Besides these fundamental goals, Banking Union also involves two practical aspects of more immediate concern that I will now address: (i) the repairing of banks' balance sheets to unclog the impaired credit channel and consolidate the on-going mild economic recovery; (ii) the reduction of the bank-sovereign loop in order to further mitigate the remaining financial fragmentation⁶. I will complete my remarks by addressing the role of the SRM as the necessary complement to the SSM in the Banking Union and finally, by dwelling upon the broader implications of Banking Union for European Integration. I will only briefly touch upon the SSM as my colleague Danièle Nouy will elaborate on SSM issues during her speech later today.

Bank recapitalisation and the economic recovery

In the past few years, one could hear many voices urging European policy makers to repair the balance sheets of banks so that these could again lend to the real economy and jump start GDP growth. There will be no growth without finance, the narrative goes. In this vein, the fact that the U.S. has returned to robust economic growth faster than Europe has been, to a large degree, attributed to policy-makers acting quickly to repair the balance sheets of U.S. banks.

This narrative, while intuitively compelling, is missing two crucial points. The first is that euro area bank balance-sheet repair has started for some time already. As I recalled recently⁷, since the onset of the global financial crisis, the top 20 European banks have increased capital, net of share buy-backs, by higher amounts than the corresponding top 20 American banks: USD 289 billion by EU banks against USD 179 billion by U.S. banks. And according to the FDIC, the leverage ratios of the biggest European banks, calculated according to the same accounting standards, are very close to their American peers⁸. Furthermore, since mid-last year in particular, European banks have implemented write-offs and increased provisions and capital, partly anticipating the Comprehensive balance-sheet Assessment that the ECB is conducting this year. Our estimates based on public information indicate that SSM banks (comprising 128 institutions) have, from July 2013 to April 2014, strengthened their balance-sheet by EUR 104 billion. Measures taken include: EUR 34 billion through issuance of quoted shares (implemented and publicly announced), EUR 15 billion through the issuance of contingent capital hybrids or EUR 19 billion relating to additional provisioning. As a result, confidence in the euro area banking sector has improved and since the first quarter of last year, banks' stock prices have risen at almost double the rate of the market average growth.

But even if we were to agree that completing the strengthening of European banks is a *necessary* condition to consolidate the recovery, it is far from being a *sufficient* condition for jump starting growth in Europe. I caution that even a complete rehabilitation of the euro area's banking system (which is well on its way thanks to the various policy steps related to the Banking Union) will not guarantee a quick return to high growth and low unemployment. In fact, there are a number of challenges, both immediate and particularly medium-term ones, that the euro area economy is facing and which are potentially more difficult to overcome than repairing the banking sector. Let me name a few: in spite of the confirmed on-going economic recovery, investment is still 20% below its 2007 level; there is a general weakness of demand and medium-term challenges to introduce structural reforms necessary

⁶ Vítor Constâncio "Banking Union: meaning implications for the future of banking" speech at Banking Union Conference organised by Master in Banking and Financial Regulation, Navarra University, Madrid, 25 of April 2014.

⁷ Vítor Constâncio "Growing out of the crisis: is fixing finance enough?" speech at the Levy Institute Hyman Minsky Conference on The state of the US and the World economy, Washington DC, 10 April 2014 (see ECB site).

⁸ "Basel III Capital: A Well-Intended Illusion", remarks by FDIC Vice-Chairman Thomas M. Hoenig to the International Association of Deposit Insurers, 2013 Research Conference in Basel, Switzerland.

for a quantum leap in total factor productivity are compounded by negative demographic developments. In fact, in the near future, the European workforce will start declining by 0.6% a year until 2030.

Of course, this is not to say that financial sector weaknesses are not important, or sufficiently recognised. The broad Comprehensive Assessment that we have started reflects precisely the importance of balance-sheet repair. My point is rather that while the on-going deleveraging in the banking sector certainly plays an important role in the inadequate current levels of credit supply to the real economy, factors related to the demand side may play an even more important role. The weak demand outlook combined with the slack in industrial capacity is the most important explanation for the drop in private investment since the crisis, and the most relevant limiting factor for future investment. In addition, the protracted period of low inflation and consequent low nominal growth will increase the burden of the debt overhang of households and governments, further complicating the recovery process.

The separation of banks from sovereigns

As I mentioned before, the goal of separating the fortune of banks from that of the sovereigns and vice-versa through direct European recapitalisation of weak banks via the European Stability Mechanism (ESM) was present in the embryo of what later became the Banking Union project. Somewhat ironically, however, this widening of the focus caused the initial objective to become obscured. The question of European direct recapitalisation – for which a framework has still not been published – ceased to be the main focus of attention. In the view of many commentators, the SRM became the expected instrument to achieve the separation between banks and sovereigns. But I think this is a somewhat misleading view as I will explain later.

The SSM and the SRM, both components of the Banking Union thus contribute to reducing the negative feed-back loop between banks and sovereigns. One important objective of the SSM Regulation is to improve the quality of supervision and to ensure strong homogenous supervisory standards across the euro area. The essential contribution that European supervision can give to the separation of banks and sovereigns is the build-up of trust in the robustness of banks as stand-alone entities, so that enhanced confidence by their peers can help normalise interbank markets and overcome financial fragmentation.

The establishment of the SRM also addresses the problem of breaking the bank-sovereign nexus because the orderly resolution of banks, even large ones, helps to avoid costly rescues by sovereigns that may endanger their own finances.

In practice, however, the SSM and SRM may not be sufficient to completely sever the ties between sovereigns and their domestic banks. The effect of SSM and harmonised supervision on trust among banks may be more limited than expected, while the SRM, important for organising orderly resolutions, is limited in the amount of resources it can contribute to recapitalisations.

The Bank Recovering and Resolution Directive (BRRD) is in my view the most crucial regulatory change in Europe in relation to breaking the bank-sovereign nexus. It represents a true paradigm change, ending the culture of bail-out and ushering in a culture of bail-in. As of 2016, in all resolution cases, the BRRD will require a bail-in of shareholders and creditors equal to at least 8% of total liabilities of a given bank, including own funds. Only after the 8% threshold of bail-in is attained can money from the resolution fund be used and for a maximum amount of 5% of total liabilities (including own funds) of the concerned bank. Public money for recapitalisation, either national or European, can thus only be considered at the very end of the process after the other two sources of remedial action have been used. Furthermore, the “government financial stabilisation tools” that the Directive introduces is an instrument of last resort after having assessed and exploited the other resolution tools to the maximum extent possible.

The amount of 8% is very substantial compared to the losses banks faced in the recent crisis. To give you an idea, between 2008 and 2010 only one bank had losses exceeding the 8% threshold, and the average for all other banks was slightly less than 3%. Thus, under the BRRD, the injection of public money into banks, either from national governments or from direct European recapitalisation, will happen only in quite rare occasions. Bail-in of shareholders and creditors plus the use of the Resolution Fund should in most conceivable cases be enough to cover the losses incurred by a failing bank. Consequently, part of the debate about direct European recapitalisation and about the role of the SRM in delinking banks and sovereigns, was *post-factum* somewhat misplaced.

The implications of this Directive are therefore far-reaching. Participant countries in the Banking Union are shedding considerable sovereign power. In fact, large countries with strong public finances are effectively renouncing their ability to provide domestic banks with the implicit subsidy of public support that would reinforce their advantages in increasing their market share. The strength of these banks when competing in the European market will be reduced as the new situation will be progressively reflected in their ratings and funding costs. Similarly, countries with vulnerable public finances and smaller banks will no longer be able to support and possibly not be able to keep their national champions. In accepting the transfer of supervision and resolution of banks to the European level, euro area countries are committing to a remarkable sharing of sovereignty which could be a positive sign of their willingness to deepen European integration in general.

It is worth mentioning that the BRRD rules about bail-in enter into force only in January 2016. They will therefore not apply to the recapitalisations in the context of the Comprehensive Assessment that the ECB is conducting and to be implemented this year and the next. The bail-in rules that will be then in place stem only from the European Commission's communication on "State Aid rules to support measures in favour of banks in the context of the financial crisis" of July 2013, which establishes that any public support to banks considered as State Aid should be preceded by bail-in of bank shares, capital hybrids and subordinated debt. The text contemplates that exceptions "can be made where implementing such measures would endanger financial stability or lead to disproportionate results". For specific cases at the end of the Comprehensive Assessment, it may be adequate to invoke such principles.

On a more general note, it is clear that to avoid moral hazard, any public interventions should penalise shareholders and managers appropriately, as was done in the exemplary case of the Nordic banking crisis. Here financial and economic collapse was avoided with, in the end, virtually no costs for taxpayers when the restored banks were sold. Thus, after the misbehaviour of several institutions that triggered the recent crisis – which by the way is still being uncovered – I fully support the change of culture from easy public bailouts to a new culture of private bailing-in. The burden of proof should be put on those who want to invoke exemptions to the new approach.

Yet, we need to bear in mind that it is not only direct public support for banks that has a cost for taxpayers, but also financial instability – indeed, the costs of the latter may be higher. Compare the worldwide costs for taxpayers stemming from the absence of public intervention to rescue Lehman Brothers, with the zero cost for taxpayers following the US TARP 700 billion dollars injection into US banks in 2008 which have by now been totally repaid by the banks. In other words, financial instability can have a meaningful cost to taxpayers even if it is not visible in the very short term – a notion that all policy makers should keep in mind.

The new European legislation does allow, as a last resort, for interventions that can safeguard financial stability in a Member State or in the area as a whole. I trust that this legislation will be applied by the competent authorities with rigour, wisdom and a sense of proportion in the aftermath of our Comprehensive Assessment.

SRM as a necessary complement to the SSM

My remarks about the SRM – as a mechanism less relevant than the BRRD rules for the severing of the bank-sovereign nexus – do not aim to belittle the crucial importance of the SRM for Banking Union. To begin with, the implementation of the BRRD bail-in rules will be done by the SRM at the European level. The credibility of the SSM as supervisor is also dependent on the existence of a credible mechanism to proceed swiftly, orderly and efficiently in the resolution of banks that have attained the point of non-viability.

The crisis showed that the cooperation and coordination between national resolution authorities is often incapable of taking swift and efficient decision on cross-border bank failures. In past cases, national interests tended to prevail, even if resolution costs became larger. In the SRM, the Single Resolution Board will take the resolution decisions for all cross-border banks and all banks under direct ECB supervision. Resolution decisions can be taken under a common interest, in swift and unbiased fashion, notably in the case of cross-border cases, while taking into account spill-overs and contagion risks.

A robust SRM, as a complement to the SSM, will address all these shortcomings. The ECB has always been of the view that a robust SRM should contain key essential features for effective resolution, namely: (a) a single system, (b) a single authority with efficient decision-making procedures (c) a single fund and (d) a backstop facility for bridge financing. We have stated this in our opinion on the SRM proposal as well as in many speeches. I am therefore very pleased that the agreed SRM regulation broadly fulfils these criteria.

A single system

To begin with, the SRM follows an integrated approach, in which all banks of EU Member States that participate in the SSM fall under the SRM. Any Member State outside the euro area which opts to join the SSM will thus automatically also fall under the SRM.

The powers of the SRM will embrace all resolution tasks, e.g. from assessing the resolvability of banks and drawing up resolution plans, to deciding on resolution schemes for failing banks and whether to make use of the Fund in such cases. These tasks are shared between the Board at the European level, which is directly responsible for all banks under direct ECB supervision and all cross-border banks, and the national resolution authorities, which are responsible for the other banks.

However, the Board may at any time decide to directly exercise all the relevant powers under the Regulation with regard to any of the indirectly supervised banks. In addition, the Board also becomes directly involved whenever a resolution of an indirectly supervised bank will make use of the Fund. Finally, there is also an option for Member States to choose that the Board will be responsible for all banks in their jurisdiction. These features make the SRM a single system.

The Single Resolution Board

At the centre of the SRM there needs to be a single authority with operational independence and sufficient decision-making authority to take resolution action in the interest of the euro area and of the Union as a whole. This is achieved with the setting up of the Single Resolution Board.

The Board will meet in two different compositions: the plenary and the executive sessions. The executive session will consist of a Chair, four independent full-time members and two observers from the Commission and the ECB, respectively. The plenary session will encompass all members of the SRB, which – on top of the ones just mentioned – will include

one member appointed by each participating Member State, representing the national resolution authorities.⁹

The fact that the ECB will be an observer in the Board, with no voting rights, is supported by the ECB. This accurately reflects the need to have the supervisor involved in resolution matters, while maintaining the necessary separation of institutional responsibilities between the supervisory and resolution function in the Banking Union.

The decision-making within the Board is designed to enable taking resolution action in the interest of stability within the euro area and of the Union as a whole. In particular, decisions in the executive session should be made by consensus. If the executive session is not able to reach a joint agreement by consensus, the Chair and the permanent members will take a decision by a simple majority. By reaching a decision either by consensus or by a majority, efficient a European decision-making should be ensured.¹⁰

Decision-making in resolution

It is important that the decision-making process in the SRM allow for timely and efficient decision-making, if necessary, within a very short time such as a weekend. It is therefore welcomed that the decision-making process in the SRM is capable of this, in spite of the fact that it may involve both the Commission and the European Council. Let me describe this process as simply as I can.

If all the conditions for resolution are met, the Board will adopt a resolution scheme for the institution or group in question, which is thereafter transmitted to the Commission. This may be fairly straight-forward if the scheme is based on agreed and adequate ex-ante resolution planning for the institution or group in question, and preparations for resolution had been taken prior to the triggering point.

The Commission can approve the resolution scheme from the Board in two ways: approving it upfront or raising no objections within 24 hours. After this, the resolution scheme is adopted and can be implemented by the national resolution authorities as instructed by the Board. It is an important feature of the final text that the European Council only becomes involved in the decision-making at the explicit request of the Commission.¹¹

⁹ The plenary session will take decisions by simple majority when it discusses issues of a general nature, such as the annual work programme, the budget, or the rules of procedure. Each member will have one vote, and in case of a tie the Chair will have the casting vote. The executive session will prepare all decisions concerning resolution procedure and adopt those decisions. When deliberating on the resolution of a bank or group, the executive session will also involve the members of the directly concerned Member States in the decision-making process. Each member, including the Chair, will have one vote. In neither session will the observers have a vote.

¹⁰ There are exceptions to this division of responsibilities between the plenary and executive sessions. First, whenever a resolution scheme would require the use of the Fund above certain thresholds, which levels depend on what the Fund's means will be used for, a member of the plenary can within a strict deadline request the plenary session to decide. In such a case, the decision will be taken by a simple majority of the plenary members, but the majority must also represent certain levels of contributions to the Fund. Second, any decision which would involve the raising of ex post contributions from the banks or voluntary borrowing between financing arrangements, among other things, will also be taken by the plenary session. During the transitional period, such decisions require a majority of 2/3 of the plenary members, representing at least 50% of contributions to the Fund. In the steady state, after eight years, the same majority share of the plenary only need to represent at least 30% of contributions to the Fund to take such decisions.

¹¹ This would be the case when the Commission does not agree with the scheme adopted by the Board. In such case, within 12 hours from receiving the resolution scheme from the Board, the Commission may propose to the Council to either: (i) object to the resolution scheme on grounds that there is no public interest of resolution, or (ii) approve or object to a material modification of how much the Fund is used in the resolution scheme. In such a case, the Council should, still within these first 24 hours, either approve or object to the Commission's proposal by a simple majority decision. In other words, they cannot amend it, only approve or

The Single Resolution Fund

Turning to the Fund, the Board's control of a common resolution fund is an essential element of the SRM. The Fund will be key to ensure adequate resolution financing without drawing on public funds and for taking swift actions, since it eliminates the need for protracted burden-sharing discussions for cross-border banks.

Although the SRM Regulation set up the Fund, the order by which bank contributions are raised at national level and pooled at EU level are detailed in accordance with an Intergovernmental Agreement on the transfer and progressive mutualisation of those contributions into a single fund. According to the political agreement reached, the target level for the Fund will be 1 % of the amount of covered deposits of all banks authorised in the participating Member States. This target should be reached in eight years, with the gradual mutualisation being frontloaded with 40% of the total in the first year.

During the transitional period of eight years, the contributions collected at national level will be allocated to separate national compartments corresponding to each participating Member State. These national compartments will be subject to progressive mutualised usage and will cease to exist at the end of the transition period. If there is a need to draw on the Fund in the transition period, the Intergovernmental Agreement lays out a funding pecking order, which should be used by the Board.¹²

Surely, one cannot rule out that situations may arise where the means available in the Fund are insufficient, e.g. because they are currently being tied up in an on-going resolution case, and where ex post contributions cannot be accessible in a timely manner. For the credibility of the Fund, and thereby the SRM and the Banking Union as a whole, it will be of paramount importance that effective and sufficient financing of the Fund is ensured.

The ECB pleaded for the creation of a credit line to be made available as it is the case the American FDIC or that, in alternative, that the Fund could go to the financial markets to raise resources with the guarantee of Member States. In the end, the final text only mentions that there is an obligation of the Board, in cooperation with the participating Member States, to take the necessary steps to develop the "appropriate methods and arrangements" that will boost of the borrowing capacity of the Fund by the date the SRM will be applicable.

Nevertheless, it is somewhat encouraging that in addition the Inter-governmental Agreement specifies that a common backstop will be developed during the transition period of the Fund. Such a backstop will undoubtedly facilitate borrowings by the Fund. Let me be clear, however, that in an event that the credit line to the backstop would temporarily be drawn upon, it will be subject to the principle of fiscal neutrality, i.e. the banking sector will ultimately be liable for repayment by means of contributions in all participating Member States, including ex post contributions.

reject to it. If the Council approves the proposal of the Commission, the Board must modify the resolution scheme accordingly within 8 hours.

¹² In the first instance, national compartments of the directly affected Member States will be used, up to a predefined limit set for each year in the transition period. This limit will decrease during the transition period. Starting at 100% in the first year, it will decrease to 60% and 40% for the second and third year, respectively. Thereafter the limit will decrease linearly for the subsequent years. As a second step, only if the first step was insufficient, available means in all compartments – including the ones just used – will contribute up to another predefined limit, also set for each year in the transition period. As I mentioned earlier, the pace of mutualisation is substantially frontloaded, starting at 40% in the first year. It will increase to 60% in the second year and thereafter increase linearly for the subsequent years until it reaches 100%. As a third step, to be used if the previous steps were insufficient, any remaining resources in the national compartments of the directly affected Member States will be used. If these three steps are still insufficient, ex post contributions from the institutions authorised in the affected Member States will be used. However, if such contributions are not immediately accessible, including for reasons relating to financial stability, the Board may exercise its power to contract borrowings or other forms of support for the Fund, or to make temporary transfers between national compartments.

Banking Union and European Integration

I mentioned before that the Banking Union complementing Monetary Union will have far-reaching implications for European integration in general as it implies a vast sharing of sovereignty. European construction is still under the grips of the Jean Monnet functional method of integration: at each new reform step, other become logical and pressing. Regarding Banking Union itself, the other element that should complement centralised supervision and bank resolution in a banking union concerns a centralized deposit insurance scheme.

Such a scheme would have several benefits. It would be commensurate to the centralized supervisory regime, and ensure that decisions that are taken on a centralized level affect depositors in all countries in the same way, thus ensuring a level playing-field. Depositors would be treated in a uniform way across countries, independently of their location and the location of the bank to whom they have entrusted their savings.¹³

What was achieved in December 2013, when the co-legislators agreed on the Deposit Guarantee Scheme Directive (DGSD) was only a little part of what in the end will be necessary. Undoubtedly, the DGS Directive will further strengthen and harmonise depositors' protection, thereby enhancing financial stability in the EU. It will ensure that deposits will continue to be guaranteed up to €100 000, per depositor and bank, in all Member States. Furthermore, it will strengthen the financing of the DGS in all Member States, notably by requiring a significant level of ex-ante funding (0.8% of covered deposits) to be met in ten years. However, a full-fledged scheme to foster financial integration would imply the setting up of a euro area wide deposit protection scheme. In particular in times of widespread financial instability, deposit insurance payoffs depend not only on the legal framework they are based on, but also on the ability of the deposit insurance fund to cope with large-scale banking failures. Doubts on this ability, due to concerns on the fiscal health of the sovereign, could for instance easily reinforce the possibility of local bank runs.

From a central bank perspective, the establishment of a common deposit insurance scheme is of less urgency than the other components of a Banking Union. Still, it is an important element that that should be pursued later, as it will be important to fend off bank runs on cross-border banks, thereby enhancing trust in the European banking sector.

The completion of Banking Union is however not the end of the journey. For instance, I mentioned before that Banking Union will tend with time to consolidate the banking sector and open the possibility for an increased role of capital markets in diversifying the financing of the European economy. However to fully reap the benefits of capital markets integration we need legislative changes that complete the programme of financial services integration, particularly in relation to the capital markets. That would include changes to company law, bankruptcy rules and procedures, and higher harmonisation in the taxation of financial products. I would urge the Commission to promote these issues.

Other necessary institutional developments have also been well identified in the President Van Rompuy's Report "Towards a genuine Economic and Monetary Union".¹⁴ They include the reference to progress towards fiscal union, economic union and political union.

First, a more complete Fiscal Union along the lines described in that Report seems necessary for the euro area, which goes beyond mere disciplinary rules. Specifically, it calls for the euro area "*...the establishment of a fiscal capacity to facilitate adjustment to*

¹³ Dirk Schoenmaker and Daniel Gros "A European Deposit Insurance and Resolution Fund: An Update" DSF Policy Paper Series September 2012.

¹⁴ See "Towards a genuine Economic and Monetary Union" a Report by the President of the European Council in close collaboration with the Presidents of the European Commission, the Eurogroup and the ECB, (<http://www.european-council.europa.eu/the-president/eurozone-governance>).

economic shocks. This could take the form of an insurance-type mechanism between euro area countries to buffer large country-specific economic shocks.”

Second, under the umbrella of Economic Union, we need further progress towards the completion of the single market in services, and a more co-ordinated approach to macroeconomic policy at the euro area level.

Finally, the sovereignty-sharing that monetary union represents implies moving forward towards political union. We need now to complete the integration of European nations. The political union pillar, is needed to ensure that the other pillars have sufficient democratic legitimacy. I will not dwell long on this issue, as it is fundamentally a matter for the Member States and European citizens. It should suffice to say that the crisis has shown the limits of applying a national mind-set in a deeply integrated monetary union. In this sense, political union is not about moving forward, but about catching up with the depth of economic and financial integration that already exists.

What is at stake refers basically to democratic accountability and legitimacy. An important element of legitimacy has been provided in the past, in the European Union and other democracies, by what Fritz Scharpf called output legitimacy (or government for the people)¹⁵, that is, by the effectiveness of the system in ensuring the continuous improvement of the citizens' quality of life. All advanced democratic countries and consequently the European Union will face challenges in this front stemming from the prolonged period of slow economic growth that has now just started. This is the consequence of two types of processes. First, the adjustment, in the form of balance-sheet recession, that the crisis represented. Second, by the structural problems created by ageing populations, globalisation, energy and environmental risks and decreasing returns of technological progress recently underlined by Robert Gordon¹⁶.

In this context, the attention that will have to be given to the other form of political legitimacy referred by Scharpf gains accrued importance. This calls for greater participation by citizens in European decisions. In some ways, it may stand-out as contradictory with the search for effectiveness linked with the first form of legitimacy requiring stronger central deciding bodies. To understand the great difficulty in addressing this issue, we could establish an analogy with the political trilemma of the world economy, as recently stated by Dani Rodrik¹⁷: “we cannot simultaneously pursue democracy, national determination and economic globalization”, but I will not enter into such complications. I will recall, however, that in this context, we should never forget that Europe is unique: it is neither a nation nor a state. Political life and legitimacy continues to take place mostly at the level of nation-states. This implies that to foster legitimacy we have to act on the two levels the European and the national by giving for instance, the European Parliament a stronger euro area dimension and encouraging greater engagement of national parliaments in euro area discussions.

Conclusion

Let me conclude.

We must recognize and confront the fact that the logical steps towards deeper integration that I just mentioned seem to run against what seems to be the mood of many Europeans, on the eve of European Parliament elections. It is true that crises always open the door to

¹⁵ See F.W. Scharpf (http://www.mpifg.de/people/fs/publikation-art_en.html).

¹⁶ Robert Gordon (2012) “Is US growth over? Faltering innovation confronts the six headwinds” CEPR Policy Insight n. 63. Robert Gordon (2014) “The demise of US economic growth: restatement, rebuttal and reflections” NBER wp 19895, Feb 2014.

¹⁷ David Rodrik (2011) “*The globalization paradox: why global markets, States and Democracy can't coexist*” Oxford University Press. Antonio Fatás blog “The UK makes the Euro Area look good” May 8, 2014.

discontent and this crisis is not over yet. Some policy-makers seem too complacent in showing a sense of relief because the situation in Europe has stabilised and turned a corner, since economic growth is resuming, even if at incipient level. This sentiment is not shared by public opinion in many countries. It should rather be recognised that adjustment costs across nations and segments of the population could have been more balanced. In this context, it is useful to retain that the legitimacy of Europe has been always much more based on outcomes of growth and prosperity than on values or input legitimacy.

In any case, economists have good arguments to demonstrate, for instance, that subject to the turmoil of an international financial crisis, nations outside the euro, like the UK, Denmark or Norway did worse than the average euro area and many of its members in terms of GDP growth per aging population, since the beginning of the crisis¹⁸. Other studies, which build a counterfactual world by comparing the euro area countries with synchronised non-euro area countries in past periods, indicate that in terms of GDP and productivity growth, all countries (except Greece), did better as part of the euro area than they would have done outside the currency union.¹⁹

We know nevertheless that times of crisis are not favourable to rational arguments and Goya famously illustrated how the sleep of reason engenders monsters. The same reasoning underlines the renowned Vienna Lecture of May 1935 by the German philosopher Edmund Husserl²⁰ as he characterised the European crisis of that time as “a collapse of rationalism”. In those more ominous times his conclusion was: “The existential crisis of Europe has only two outcomes: either Europe will disappear in becoming ever more distant from its own rational signification, that is its vital sense, and will sink in the hatred of the spirit and in barbarity; or Europe will be reborn from the philosophical spirit as a result of a heroism of reason that will overcome naturalism. ... Europe’s greatest danger is weariness. Let us as “good europeans” do battle with this danger of dangers with the sort of courage that does not shirk even the endless battle”. He was right then. And today, Europe seems a tired and aged continent. Declining demography, under the heading of “no children, no immigrants” is historically a sign of a declining civilisation. In these grim years of crisis, our nations, ever more interdependent, have been bound mostly in a community of fear. We now need that European leaders return it into a community of hope.

Thank you for your attention.

¹⁸ Antonio Fatás blog “The UK makes the Euro Area look good” May 8, 2014.

¹⁹ Nauro Campos, F Coricelli, L. Moretti “How much do countries benefit from membership in the European Union?” VoxEu, 9 April 2014.

²⁰ Edmund Husserl “Philosophy and the crisis of European Man” in *“Phenomenology and the crisis of Philosophy”*, Harper Torchbooks, 1965, also available in www.users.cloud9.net/~bradmcc/husserl_philcris.html.