

Banking Europe: Strength in the Union?

By [Céline Antonin](#) and [Vincent Touzé](#)

On 4 November 2014, the European Central Bank became the single supervisor of banks in the euro zone. This was the first step in the banking union.

The economic and financial crisis that started in 2007 has exposed several European weaknesses:

1. The national bank markets, though seemingly compartmentalized, proved to be highly interdependent, as was seen in the high level of propagation-contamination;
2. There was often a lack of coordination in the national support provided;
3. Given the context of high public indebtedness, State support for the bank system led to a strong correlation between bank risk and sovereign risk;
4. The absence of fiscal transfer mechanisms strongly limited European solidarity.

In 2012, the idea of a banking union arose out of a triple necessity: to break the link between the banking crisis and the sovereign debt crisis by enabling the direct recapitalization of troubled banks through the European Stability Mechanism; to prevent bank runs; and to prevent the euro zone banking markets from fragmenting.

The banking union is being built on three pillars: a single supervision mechanism (SSM); a single resolution mechanism (SRM), with a resolution fund and a bail-in process; and a single deposit guarantee system with a guarantee fund.

The banking union sets out new solutions. Nevertheless, grey

areas remain, and the European solidarity provided by the banking union could prove insufficient to deal with major shocks.

The latest [Note de l'OFCE](#) (no. 46 of 18 November 2014) reviews the context surrounding the establishment of the banking union and takes stock of the advantages and limitations of the progress made in constructing the union. This Note was produced as a special study entitled "[Comment lutter contre la fragmentation du système bancaire de la zone euro?](#)", [How can the fragmentation of the euro zone banking system be fought?] *Revue de l'OFCE*, no. 136 (2014).

Cyprus: Aphrodite to the rescue?

By [Céline Antonin](#) and [Sandrine Levasseur](#)

For two weeks Cyprus sent tremors through the European Union. If the banking crisis that the island is going through has attracted much attention, it is essentially for two reasons. First, because the dithering over the rescue plan led to a crisis of confidence in deposit insurance, and second, because it was the first time that the European Union had allowed a bank to fail without coming to its aid. While the method of resolving the Cyprus crisis seems to represent an institutional advance [\[1\]](#), insofar as investors have been forced to face up to their responsibilities and citizens no longer have to pay for the mistakes of the banks, the impact of the purge of the island's real economy will nevertheless be massive. With its heavy dependence on the banking and

financial sector, Cyprus is likely to face a severe recession and will have to reinvent a growth model in the years to come. In this respect, the exploitation of natural gas resources seems an interesting prospect that should not be ruled out in the medium / long term.

To grasp what is at stake in Cyprus today, let us briefly recall the facts. On 25 June 2012, Cyprus requested financial assistance from the EU and the IMF, essentially in order to bail out its two main banks (Laiki Bank and Bank of Cyprus), whose losses are estimated at 4.5 billion euros due to their high exposure to Greece. Cypriot banks were hit both by the depreciation of the Greek assets they held on their balance sheets and by the partial write-down of Greek debt under the second bail-out plan (PSI Plan of March 2012 [\[21\]](#)). Cyprus estimated that it needed 17 billion euros in total over four years to prop up its economy and its banks, about one year of the island's GDP (17.9 billion euros in 2012). But its backers were not ready to give it this much: the national debt, which had already reached 71.1% of GDP in 2011, would become unsustainable. The IMF and the euro zone thus came to an agreement on a smaller loan, with a maximum amount of 10 billion euros (9 billion financed by the euro zone and 1 billion by the IMF) to recapitalize the Cypriot banks and finance the island's budget for three years. Cyprus was in turn ordered to find the remaining 7 billion through various reforms: privatizations, an increase in corporate tax from 10 to 12.5%, and a windfall tax on bank deposits.

Initially [\[31\]](#), Nicosia decided to introduce a one-off tax of 6.75% on deposits of between 20,000 and 100,000 euros and 9.9% on those above 100,000 euros, and a withholding tax on interest on these deposits. Given the magnitude of the resulting protest, the government revised its approach, and the taxation of deposits gave way to a bankruptcy and restructuring. The solution adopted concerned the country's two main banks, Laiki Bank and Bank of Cyprus. Laiki was

closed and split into two: first, a “good bank” that will take over the insured deposits (less than 100,000 euros) and the loans from the ECB to Laïki [4], but which will also take over its assets and ultimately be absorbed by Bank of Cyprus; and second, a “bad bank” that will accommodate the stocks, bonds, unsecured deposits (above 100,000 euros), and which will be used to pay off Laïki’s debts [4], according to the order of priority associated with bank liquidations (depositors being paid first). In addition to absorbing the “good bank” hived off of Laïki, Bank of Cyprus will freeze its unsecured deposits, some of which will be converted into shares to be used in its recapitalization. To prevent a flight of deposits, temporary [5] capital controls were put in place.

This plan introduces a paradigm shift in the method of resolving banking crises in the European Union. At the beginning of the euro zone crisis, in particular in the emblematic case of Ireland, the European Union considered that creditors had to be spared in the event of losses, under the logic of “too big to fail”, and it called on the European taxpayer. But in 2012, even before the declaration of Jeroen Dijsselbloem, Europe’s doctrine had already begun to bend [6]. Hence, on 6 June 2012, the European Commission proposed a Directive on the reorganization and resolution of failing credit institutions, which provided for calling on shareholders and bondholders to contribute. [7] However, the rules on creditors are to apply only from 2018, after approval of the text by the Council and the European Parliament. This type of approach is now being tested experimentally in the Cyprus crisis.

Heavy consequences for the real economy

The situation of the country before 2008

In the period preceding the global economic crisis, the Cypriot economy was thriving, and indeed in 2007 even in danger of overheating. Over the period 2000-2006, its GDP grew

on average by 3.6% per year, with growth of 5.1% in 2007. The unemployment rate was low (4.2% in 2007), with even some labour shortage as a result of the emigration of Cypriot nationals to other EU countries. The influx of foreign workers into Cyprus helped to hold down wages. Consumer spending and, to an even greater extent, business investment, which were largely financed through credit, were particularly dynamic starting in 2004, with growth rates that in 2007 reached, respectively, 10.2% and 13.4%. Inflation was moderate, and in this generally positive context, Cyprus qualified to adopt the euro on 1 January 2008.

In this pre-crisis period, the Cypriot economy – a small, very open economy – relied in the main on two sectors: tourism and financial services.

The two key sectors of the Cypriot economy

Revenue from tourism (Table 1) has provided a relatively stable financial windfall for the Cypriot economy. This (non-cyclical) flow brings in approximately 2 billion euros annually. [\[8\]](#) As a share of GDP, however, the weight of tourism has decreased by half since 2000, to a level of less than 11% in 2012. Likewise, the share of tourism in the export of services fell sharply during the last decade: in 2012, it accounted for 27% (against 45% in 2000). Over the last 15 years, the number of tourists has fluctuated somewhat between 2.1 million (in 2009) and 2.7 million (2000), compared with about 850,000 people who are residents of the island.

Financial services constitute the other pillar of the Cypriot economy (Table 2). Two figures give a clear idea of its significance: bank assets accounted for more than 7.2 times GDP in 2012 (with a maximum of 8.3 achieved in 2009), and the stock of FDI in the sector “Finance & Insurance” is estimated at more than 35% of GDP, *i.e.* more than 40% of all FDI inflows.

Table 1. Weight of tourism in Cyprus

	2000	2004	2009	2012
Tourist revenue				
In millions of €	2 040,1	1 678,4	1 493,2	1 926
In % of GDP	20,5	13,3	8,9	10,8
By tourist (In €)	759	715	697	781
In % of services exports	44,8	32,6	25,0	26,8
Tourists (1000s of people)	2 686	2 349	2 141	2 465

Source: Central Bank of Cyprus and National statistical office. Author's calculations.

Table 2. Weight of the banking sector in Cyprus

	2007	2008	2009	2010	2011	2012
Banking assets						
In billions of €	92,9	118,1	139,4	135,0	131,6	128,1
Relative to GDP	5,8	6,9	8,3	7,8	7,3	7,2
Stock of FDI in the Finance and Insurance sector						
In billions of €						6,4
In % of GDP						35,6
In % of total FDI						41,6

Source: Central Bank of Cyprus and National statistical office. Author's calculations.

As major sources of wealth for the Cypriot economy, these two sectors have played an important role by, at least until 2007, compensating (partially) the considerable deficit in the balance of payments, which has risen continuously since the early 1990s and fluctuated at around 30% of GDP since 2000 (Table 3). The “fuel” bill has been an increasing burden on imports into Cyprus, mainly due to higher oil prices: the energy bill has tripled over the last decade, rising from 461 million euros in 2000 to 1.4 billion in 2011. As a percentage of GDP, the rise in energy costs has also been very visible, as it has shot up from 5% of GDP in 2000 to 8% in 2011.

Reducing the size of the financial sector therefore raises the question of a new growth model for the Cypriot economy, *i.e.* its “industrial conversion”.

Table 3. Extract from the balance of payments of Cyprus

In millions of € (unless stated otherwise)

		2000	2004	2007	2008	2009	2010	2011
Balance of goods								
Exports	Total	1 011	936	1 083	1 190	971	1 137	1 404
	o/w "re-exports"	600	521	578	643	491	570	777
Imports	Total	4 104	4 578	6 353	7 367	5 692	6 517	6 311
	o/w "fuels"	461	503	895	1 247	880	1 157	1 381
Exports - Imports	Total	-3 093	-3 641	-5 271	-6 176	-4 721	-5 381	-4 907
	Total (% of GDP)	-31 %	-29 %	-33 %	-36 %	-28 %	-31 %	-27 %
Balance of services								
Exports	Total	4 552	5 147	6 579	6 538	5 779	6 049	6 262
Imports	Total	1754,40	2 201	2 841	2 937	2 416	2 467	2 676
Exports - Imports	Total	2 797	2 946	3 739	3 601	3 363	3 583	3 586
	Total (% of GDP)	28 %	23 %	24 %	21 %	20 %	21 %	20 %
Balance of goods and services								
Exports - Imports	Total	-295	-696	-1 532	-2 575	-1 358	-1 798	-1 321
	Total excl. "fuels"	165	-192	-637	-1 328	-479	-641	60
	Total (% of GDP)	-3 %	-6 %	-10 %	-15 %	-8 %	-10 %	-7 %
	Total excl. "fuels" (% of GDP)	2 %	-2 %	-4 %	-8 %	-3 %	-4 %	0 %

Source: Office statistique national, Eurostat et banque centrale de Chypre. Calculs des auteurs.

The temptation to exit the euro

The plan decided by the Troika undermines the island's growth model by penalizing the country's hyper-financialization, and condemns it to years of recession. To avoid a long convalescence, the idea of leaving the euro zone has taken root, as it did in Greece. However, leaving the euro zone is far from a panacea. Regaining monetary sovereignty undeniably offers certain advantages, as is described by C. Antonin and C. Blot in their note, [Comparative study of Ireland and Iceland](#): first, an internal devaluation (through lower wages) would not be as effective as an external devaluation (through exchange rates); second, fiscal consolidation is less costly when it is accompanied by a favourable exchange rate policy. Nevertheless, given the structure of the Cypriot economy, we do not think that leaving the euro is desirable.

In fact, upon leaving the euro, the Central Bank of Cyprus would issue a new currency. Assuming it remains convertible, this currency would depreciate vis-à-vis the euro. By way of comparison, between July 2007 and December 2008 the Icelandic

krona lost 50% of its value vis-à-vis the euro. Such a depreciation would have two consequences:

– One, an improvement in competitiveness (the real exchange rate has appreciated by 10% since 2000), which would boost exports and help reduce the deficit in the balance of trade in goods and services (Table 1). Since the accession of Cyprus to the European Union in 2004, this balance has deteriorated as a result of several factors: first, the slowing of inflation from 2004 related to pegging the exchange rate to the euro, which encouraged the growth of real wages at a higher rate than productivity gains; and second, the boom in bank lending, with the substantial decline in risk premiums on loans as a result of accession to the EU [9]. Consumption was boosted, the competitiveness of the Cypriot economy deteriorated, and imports increased. Would exiting the euro reverse this trend? This is the argument of [Paul Krugman, who supports Cyprus leaving the euro zone](#) by evoking a tourist boom and the development of new export-oriented industries. However, according to our calculations, a 50% depreciation in the real exchange rate would result in an increase in the value of exports of 500 million euros, including 150 million from additional tourism revenue. [10] As for imports, they are weakly substitutable, as they are composed of energy and capital and consumer goods. Given the weakness of the country's industries, Cyprus will not be able to undertake a major industrial restructuring in the short or medium term. There are therefore limits to improvements in the trade balance. Furthermore, inflation would increase, including through imported inflation, which would lead to a fall in consumer purchasing power and mitigate any competitiveness gains.

– In addition, the devaluation would substantially increase the burden of the outstanding debt, but also of private debt denominated in foreign currency. Net foreign debt in Cyprus is low, at 41% of GDP in 2012. In contrast, public debt reached

70% of GDP, or 12.8 billion euros. 99.7% of the public debt is denominated in euros or in a currency that is part of the European Exchange Rate Mechanism (and thus pegged to the euro), and 53% of this debt is held by non-residents. In addition, the deficit was 6.3% of GDP. If Cyprus no longer had the euro, it would without doubt default on part of its public debt, which would temporarily deprive the country of access to foreign capital, and thus require the kind of violent fiscal consolidation that Argentina went through in 2001.

The exploitation of natural gas resources

The crisis in Cyprus raises the question of the natural gas discoveries in the south of the island in the early 2000s. According to the US Geological Survey, the Levant Basin located between Cyprus and Israel could contain 3,400 billion cu.m of gas resources. By way of comparison, [the entire EU has 2,400 billion cu.m](#) (mainly in the North Sea).

Cyprus thus has *a priori* a major natural gas bonanza, even if all of the deposits are not located in its Exclusive Economic Zone (EEZ). At present, only one out of the twelve parcels of land belonging to the Cypriot EEZ has been subject to exploratory drilling, and in December 2011 a deposit of 224 billion cu.m of natural gas was discovered. According to the Government of Cyprus, the value of this field, called Aphrodite, is estimated at [100 billion euros^{\[11\]}](#). The exploration of the other eleven parcels belonging to the Cypriot EEZ could prove successful (or even very successful) in terms of natural gas resources. As the licenses for the exploration of these eleven parcels are in the process of being awarded by the Cypriot authorities, the EU could have used the (sad) occasion of the rescue package to secure a portion of the aid granted to Cyprus on its gas potential. Why did the EU not seize on such an occasion?

For the EU, the discovery of the natural gas reserves is good news, in the sense that the exploitation of these deposits

will help it to achieve the energy diversification that it values so highly. However, several problems have arisen, problems that darken the prospects for exploiting the gas fields in the very near future. First of all, the discovery of gas reserves in the Levant basin has revived tensions with Turkey, which occupies the northern part of the island of Cyprus and which believes it has rights to the exploitation of the fields. The growing number of Turkish military manoeuvres reflects an effort to impose its presence in the areas being surveyed and could lead to an escalation of violence in the region, especially since the Greek-Cypriot authorities (the southern part) have been working with Israel to defend the gas fields. [\[12\]](#) Second, even assuming that the Greek-Turkish dispute is resolved, the exploitation of the gas will require heavy investment in infrastructure, in particular the construction of an LNG tanker whose cost is estimated at 10 billion euros. Finally, there will be no immediate return on the investment, as it will take at least eight years to put in place the necessary infrastructure. In these conditions, it is understandable why the EU did not take the opportunity to secure some of the aid to Cyprus against these gas resources: exploitation is still too uncertain and, in any case, the horizon is too distant (given the immediacy required for a response to the crisis).

Furthermore, the EU would likely wind up in an awkward situation vis-à-vis several countries. If the EU supports Cyprus in the gas dispute, this comes down to supporting Israel, at the very time that the EU is holding negotiations on Turkey's membership and is trying to build good relations in the region, including with the regimes that have emerged from the "Arab Spring". In addition, two pipeline projects are already in competition: the South Stream project, linking Russia to Western Europe by 2015, and Nabucco, connecting Iran, via Turkey, to Western Europe by 2017. A new gas pipeline connecting the Cypriot fields to the European continent would further reduce Russia's bargaining power, by

shifting the centre of gravity of natural gas southwards. This would promote greater dispersion and intensify geopolitical divisions in Europe, between a Northern Europe (including Germany) supplied by Russia and a Southern Europe dependent on the Middle East and Turkey.

Conclusion

If in the immediacy of the crisis the EU has made the right choice (that of the “bad” and “good” bank), the question is posed in the medium / long term of a new growth model for the Cypriot economy. Given the comparative advantages of Cyprus, the exploitation of natural gas seems to offer the only serious solution for the economy’s conversion. However, for this strategy to be achievable, the EU will have to take a clear position in favour of Cyprus in the Greek-Turkish dispute.

Not only would the exploitation of the gas bring Cyprus energy self-sufficiency, it would also constitute a major source of revenue for the island. Energy costs would cease being a burden on the balance of payments (Table 1). This is especially important, because, even though tourism (another pillar of the economy) has provided a stable (non-cyclical) source of income since 2000, it is not immune to geopolitical events in the region or to new competition over tourist destinations, in particular from the “Arab Spring” countries.

Consider this simple calculation. Suppose Cyprus manages to maintain its tourism revenues at the level of 2 billion euros (an assumption that, despite the caveats outlined above, is nevertheless realistic); in the absence of industrial restructuring, if the share of the banking sector in the economy is halved (as desired by the Troika and common sense), then Cypriot GDP would return to its 2003 level, or slightly less than 12 billion euros. And GDP per capita would fall by about a third...

Industrial reconversion is thus important for the Cypriot economy, just as for other economies in crisis... except that Cyprus has Aphrodite.

[1] See [Henri Sterdyniak and Anne-Laure Delatte, "Cyprus: a well-conceived plan, a country in ruins..."](#), OFCE blog, March 2013.

[2] See Céline Antonin, [Would returning to the drachma be an overwhelming tragedy?](#), OFCE Note no. 20, 19 June 2012.

[3] For more on the dithering on the rescue plan, see [Jérôme Creel, "The Cypri-hot case!"](#), OFCE blog, March 2013.

[4] These loans, granted via Emergency Liquidity Assistance (ELA), amount to 9 billion euros.

[5] Article 63 of the Treaty of the European Union prohibits restrictions on the movement of capital, but Article 64b authorizes Member states to take control measures for reasons of public order or public safety.

[6] *"If the bank can't recapitalize itself, then we'll talk to the shareholders and the bondholders. We'll ask them to contribute in recapitalizing the bank. And if necessary the uninsured deposit holders"*, statement by Jeroen Dijsselbloem, 25 March 2013, to the *Financial Times*.

[7] <http://www.revue-banque.fr/risques-reglementations/breve/les-c-reanciers-des-banques-mis-contribution>

[8] The tourist revenue of Cyprus depends in the main on tourists from Britain (43% in 2011), Russia (14%), Germany and Greece (6.5 % each).

[9] On the factors worsening the current accounts, see [Natixis, Retour sur la crise chypriote, novembre 2012](#).

[10] Estimation made using the elasticities calculated by the [IMF](#).

[11] Not far from Aphrodite, 700 billion cu.m of deposits were discovered in the Israeli EEZ, proof that the region is rich in natural gas.

[12] The tensions between Cyprus (southern part) and Israel were resolved (peacefully) by the signing of a treaty in December 2010 defining their respective exclusive economic zones (EEZ). The two entities also plan to cooperate in the construction of common infrastructures to exploit the gas. See [the analysis of Angélique Palle](#) on the geopolitical consequences of the discovery of these natural gas resources in the Levant basin.

Banking union: a solution to the euro crisis?

By Maylis Avaro and [Henri Sterdyniak](#)

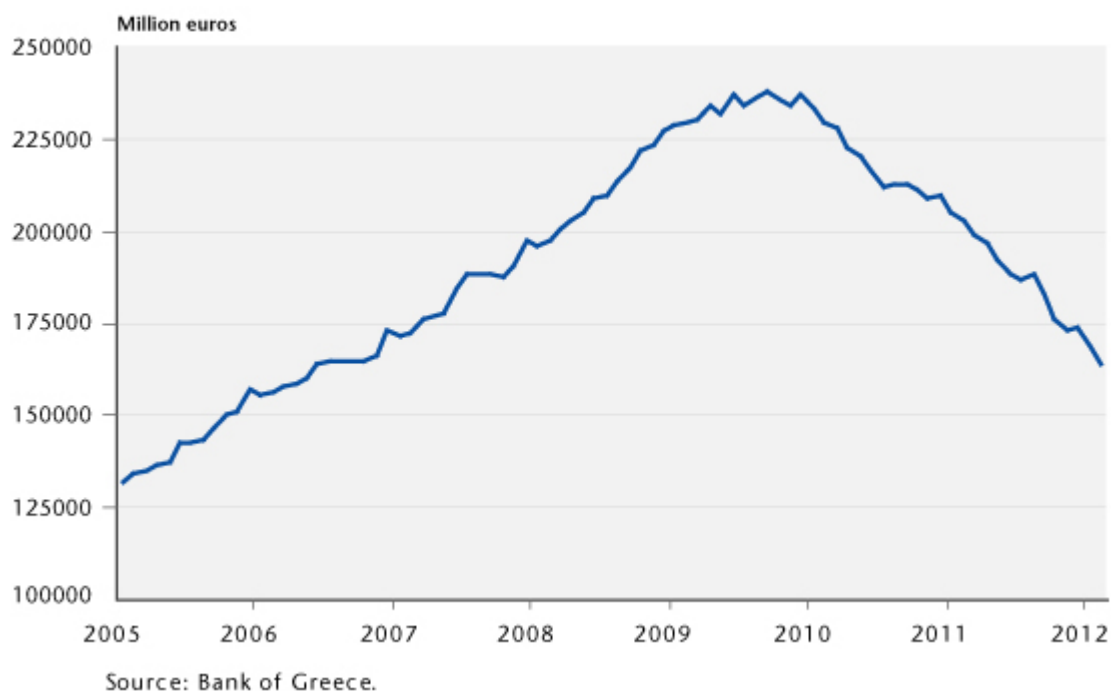
The European summit on 28th and 29th June marked a new attempt by Europe's institutions and Member states to overcome the crisis in the euro zone. A so-called Growth Pact was adopted, but it consists mainly of commitments by the Member states to undertake structural reform, and the limited funds made available (120 billion over several years) were for the most part already planned. The strategy of imposing restrictive fiscal policies was not called into question, and France pledged to ratify the Fiscal Compact. The interventions of the

European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) will now be less rigid, as, without additional conditions, they can help countries that the financial markets refuse to finance so long as they meet their objectives in terms of fiscal policy and structural reform. But euro-bonds and the mutual guarantee of public debt were postponed. The summit also launched a new project: a banking union. Is this an essential supplement to monetary union, or is it a new headlong rush into the unknown?

The current crisis is largely a banking crisis. The European banks had fed financial bubbles and housing bubbles (especially in Spain and Ireland), and they had invested in mutual funds and hedge funds in the United States. After major losses during the crisis of 2007-2010, the Member states came to their rescue, which was particularly costly for Germany, the UK, Spain and above all Ireland. The sovereign debt crisis in the euro zone has compounded their woes: the sovereign debt that they hold has become a risky asset. The problem of regulating the banks has been raised at the international level (new Basel III standards), in the United States (Volcker's rule and Dodd-Frank law) and in Britain (Vickers report).

In June 2012, doubts about the soundness of Europe's banks surfaced yet again. The measures taken since 2008 to stabilize the financial system have proved insufficient. When Bankia, Spain's fourth-largest bank, announced that it was requesting State assistance of 19 billion euros, worries about the balance sheets of Spanish banks rose sharply. The rate of bad loans of the country's banks, whose balance sheets were hit hard by the real estate crash, rose from 3.3% at end 2008 to 8.7% in June 2012 [1]. Furthermore, many Greeks, fearing an exit from the euro zone, began to reduce their deposits in the banks there [2].

Total deposits of business and consumers in Greece's banks



In response to these dangers, the proposal for a European banking union was given a new boost by Mario Monti. Italy's PM suggested developing the proposals in preparation for the European Commission Single Market DG, an idea that currently has the support of the Commission, the European Central Bank, and several Member states (Italy, France, Spain, etc.) On the other hand, Germany believes that a banking union is impossible without a fiscal union. While Angela Merkel acknowledged [3] that it was important to have a European supervisory authority, with a supranational banking authority with a better general overview, she clearly rejected the idea of Germany taking a risk of further transfers and guarantees without greater fiscal and policy integration [4]. The euro zone summit meeting on 29 June asked the Commission to make proposals shortly on a single monitoring mechanism for the euro zone's banks.

This kind of banking union would rest on three cornerstones:

- a European authority in charge of centralized oversight of the banks,

- a European deposit guarantee fund,
- a common mechanism for resolving bank crises.

Each of these cornerstones suffers specific problems: some are related to the complex way the EU functions (Should a banking union be limited to the euro zone, or should it include all EU countries? Would it be a step towards greater federalism? How can it be reconciled with national prerogatives?), while others concern the structural choices that would be required to deal with the operations of the European banking system.

As to the institution that will exercise the new banking supervisory powers, the choice being debated is between the European Banking Authority (EBA) and the ECB. The EBA was established in November 2010 to improve oversight of the EU banking system, and it has already conducted two series of “stress tests” on the banks. As a result of the tests, in October 2011 Bankia reported a 1.3 billion euro shortage of funds. Five months later, the deficit was 23 billion; the EBA’s credibility suffered. In addition, the London-based EBA has authority over the British system, while the United Kingdom does not want to take part in the banking union. The ECB has, for its part, received support from Germany. Article 127.6 of the Treaty on the Functioning of the European Union [5], which was cited at the euro zone summit of June 29th as a basis for the creation of a European Banking Authority, would make it possible to give the ECB supervisory authority. On 12 June, the Vice-President of the ECB, Mr. Constancio, said that, “the ECB and the Eurosystem are prepared” to receive these powers; “there is no need to create a new institution”.

European oversight implies a common vision of banking regulation. There must be agreement on crucial issues, such as: “Does commercial banking need to be separated from investment banking?” “Should banks be prohibited from operating on the financial markets for their own account?” “Should public or mutual or regional banks be encouraged

rather than large internationalized banks?" "Should banks be encouraged to extend credit primarily to businesses and government in their own country, or on the contrary to diversify?" "Should the macro-prudential rules be national or European?" In our opinion, entrusting these matters to the ECB runs the risk of taking a further step in the depoliticization of Europe.

Applying the guidelines of this new authority will be problematic. A banking group in difficulty could be ordered to divest its holdings in large national groups. But would a country's government expose a national champion to foreign control? Governments would lose the ability to influence the distribution of credit by banks, which some people might find desirable (no political interference in lending), but in our opinion is dangerous (governments would lose a tool of industrial policy that could be used to finance Small and Medium Enterprises [SMEs] and Economic and technological intelligence [ETI] projects or to support the ecological transition).

For example, in a case involving Dexia, the opposition between the European Commission on the one hand and France, Belgium and Luxembourg on the other is blocking a restructuring plan. The plan includes the takeover of Dexia Credit Local's financing of local authorities by a banking collectivity that would be created based on cooperation between La Banque postale and the Caisse des depots. In the name of fair competition, Brussels is challenging the financing of local communities by such a bank, as Dexia has received public funding for its restructuring plan. This is threatening the continuity of the financing of the French local authorities, and could put a halt to their plans; in particular, it could prevent France from providing specific secure mechanisms for financing local authorities through local savings.

The purpose of a deposit guarantee fund is to reduce the risk of a massive withdrawal of deposits during a banking panic.

This fund could be financed through contributions by the European banks guaranteed by the fund. According to Schoenmaker and Gros [6], a banking union must be created under a "veil of ignorance", that is to say, without knowing which country poses the greatest risk: this is not the case in Europe today. The authors propose a guarantee fund that at the outset would accept only the strongest large transnational banks, but this would immediately heighten the risk of the zone breaking apart if depositors rushed to the guaranteed banks. The fund would thus need to guarantee all Europe's banks. According to Schoenmaker and Gros, assuming a 100,000 euro ceiling on the guarantee, the amount of deposits covered would be 9,700 billion euros. The authors argue that the fund should have a permanent reserve representing 1.5% of the deposits covered (*i.e.* about 140 billion euros). But this would make it possible to rescue only one or two major European banks. During a banking crisis, amidst the risk of contagion, such a fund would have little credibility. The guarantee of deposits would continue to depend on the States and on the European Stability Mechanism (ESM), which would have to provide support funds, ultimately by requiring additional contributions from the banks.

The authority in charge of this fund has not yet been designated. While the ECB appears well positioned to undertake supervision of the banking system, entrusting it with management of the deposit guarantee fund is much more problematic. According to Repullo [7], deposit insurance should be separated from the function of lender of last resort. Indeed, otherwise the ECB could use its ability to create money to recapitalize the banks, which would increase the money supply. The objectives of monetary policy and of support for the banks would thus come into conflict. What is needed is a body that handles deposit insurance and crisis resolution and is separate from the ECB, and which must have a say on the behavior of the banks, and which would be additional to the EBA, the ECB, and the national regulators.

The ECB on the other hand would continue to play its role as lender of last resort. But it is difficult to see how such a complicated system would be viable.

As the risk of a country leaving the euro zone cannot yet be dismissed, the question arises as to what guarantee would be offered by a banking union in the case of a conversion into national currency of euro-denominated deposits. A guarantee of deposits in the national currency would, in the case of an exit from the euro, heavily penalize customers of banks that suffer a devaluation of the national currency against the euro, whose purchasing power would decline sharply. This kind of guarantee does not solve the problem of capital flight being experienced today by countries threatened by a risk of default. What is needed is a guarantee of deposits in euros, but in today's situation, given the level of risk facing some countries, this is difficult to set up.

German and Finnish politicians and economists such as H. W. Sinn are, for instance, denouncing an excessive level of risk for Germany and the Nordic countries. According to several German economists, no supranational authority has the right to impose new burdens (or risk levels) on the German banks without the consent of Parliament, and the risk levels need to be explicitly limited. The German Constitutional Court might oppose the deposit guarantee fund as exposing Germany to an unlimited level of risk. Moreover, according to George Osborne, the Chancellor of the British Exchequer, a bank deposit guarantee at the European level would require an amendment to existing treaties and the consent of Great Britain.

On 6 June, the European Commission began to develop a common framework for resolving banking crises by adopting the proposal of Michel Barnier, which has three components. The first is to improve prevention by requiring banks to set up *testaments*, that is, to provide for recovery strategies and even disposal plans in case of a serious crisis. The second

gives the European banking authorities the power to intervene to implement the recovery plans and to change the leadership of a bank if it fails to meet capital requirements. The third provides that, if a bank fails, the national governments must take control of the establishment and use resolution tools such as divestiture, the creation of a defeasance bank, or "bad" bank, or an internal bailout (by forcing shareholders and creditors to provide new money). If necessary, the banks could receive funds from the ESM. Bank-related risks would therefore be better distributed: the shareholders and creditors not covered by the guarantee would be first to be called upon, so that the taxpayers would not pay to reimburse the creditors of insolvent banks. In return, bank loans and shares would become much riskier; bank reluctance about inter-bank credit and the drying up of the interbank market due to the crisis would persist; and the banks would find it difficult to issue securities and would have to raise the level of compensation. However, Basel III standards require banks to link their lending to the level of their capital. This would pose a risk of constraining the distribution of credit, thereby helping to keep the zone in recession. Based on the decisions of the summit on 29 June, Spain could be the first country whose banks would be recapitalized directly by the ESM. However, this would not take place until early 2013; the terms of the procedure and the impact of ESM aid on the governance of the recapitalized banks still need to be determined. As can be seen in the Dexia example, what terms are set for the reorganization of a bank can have serious consequences for the country concerned: are governments (and citizens) willing to lose all power in this domain?

A banking union can help break the correlation between a sovereign debt crisis and a banking crisis. When the rating agencies downgrade a country's debt, the securities suffer a loss in value and move into the category of "risky assets", becoming less liquid. This increases the overall risk faced by the banks in the country concerned. If a bank is facing too

much overall risk and it is no longer able to meet the capital requirements of Basel III, the State must recapitalize it, but to do this it must take on debt, thereby increasing the risk of a default. This link between the banks' fragile balance sheets and public debt generates a dangerous spiral. For instance, since the announcement of the bankruptcy of Bankia, Spain's 10-year refinancing rates reached the critical threshold of 7%, whereas last year the rates were about 5.5%. In a banking union, the banks would be encouraged to diversify on a European scale. However, the crisis of 2007-09 demonstrated the risks of international diversification: many European banks lost a great deal of money in the US; foreign banks are unfamiliar with the local business scene, including SMEs, ETIs and local government. Diversification based on financial criteria does not fit well with a wise distribution of credit. Moreover, since the crisis, European banks are tending to retreat to their home countries.

The proposal for a banking union assumes that the solvency of the banks depends primarily on their own capital, and thus on the market's evaluation, and that the links between a country's needs for financing (government, business and consumers) and the national banks are severed. There is an argument for the opposite strategy: a restructuring of the banking sector, where the commercial banks focus on their core business (local lending, based on detailed expertise, to businesses, consumers and national government), where their solvency would be guaranteed by a prohibition against certain risky or speculative transactions.

Would banking union promote further financialization, or would it mark a healthy return to the Rhineland model? Would it require the separation of commercial banks and investment banks? Would it mean prohibiting banks whose deposits are guaranteed to do business on the financial markets for their own account?

[1] According to the Bank of Spain.

[2] The total bank accounts of consumers and business fell by 65 billion in Greece since 2010. Source: Greek Central Bank.

[3] “La supervision bancaire européenne s’annonce politiquement sensible”, *Les Echos Finance*, Thursday 14 June 2012, p. 28.

[4] “Les lignes de fracture entre Européens avant le sommet de Bruxelles”, *AFP Infos Economiques* 27 June 2012.

[5] Art 127.6: “The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.”

[6] D. Schoenmaker and Daniel Gros (2012), “A European Deposit Insurance and Resolution Fund”, *CEPS working document*, No. 364, May.

[7] Repullo, R. (2000), “Who Should Act as Lender of Last Resort? An Incomplete Contracts Model”, *Journal of Money, Credit, and Banking* 32, 580-605.