



Breakingviews

Guest view: Euro zone needs workable banking union

By Guest Contributor

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The governments of the 19 euro zone member countries have failed to put in place a fully comprehensive and effective banking union, despite the valiant efforts by European Central Bank President Mario Draghi. A viable common currency demands a workable common banking system.

Such a system, guided by the ECB, is essential to strengthening the banks, which have not and are not making a sufficient contribution to economic expansion. GDP growth in the 19 euro zone countries was just 0.3 percent in the third quarter of 2015. This is a failing of euro zone economic policy.

In an open-question period at a conference in London in July 2012 – the one where Draghi pledged to do “whatever it takes” to preserve the euro – I asked the ECB president about his expectations for a banking union. Draghi underscored it was vital for securing the euro and for the region’s growth. He said he expected a blueprint from the European Commission to be ready within a few months and final decisions to establish the banking union to be taken in 2013.

We are now at the beginning of 2016 and the banking union remains very much a work in progress. Supervisory authority has been consolidated to a degree in ECB hands so that finally there are meaningful bank stress tests, like the one in October 2014. Progress has been made on resolution, although recent problems with four small banks in Italy, as well as with banks in Portugal, have highlighted shortcomings in the execution and funding in this area. Indeed, sharp political debates have been sparked by the Portuguese government’s efforts to bail out Banco Internacional do Funchal (Banif), and even greater controversy may arise as the government moves forward to sell assets from the now defunct Banco Espirito Santo, once the country’s largest bank.

But there has been no progress on a key pillar of banking union: deposit insurance. For some months now, the German finance ministry has circulated a paper among European Union officials that details objections to euro zone-wide bank deposit protection. Berlin appears adamant that its citizens should not contribute to a central fund that might have to be used to support depositors in banks outside Germany. Firm language is being used to suggest that the ECB

needs to confine itself to monetary policy and not further extend its mandate in the banking sector.

One is bound to conclude that the ECB's mandate remains too narrow. Greater ECB authority could address some of the profound weaknesses in many parts of the euro zone's banking sector. After all, while America's large, robust and diverse capital markets have led to a situation where banks account for no more than 30 percent of credit generation, in the euro zone the banks dominate with around 75 percent. Their health is crucial for euro zone growth, but banks in the region are in the midst of curbing investment banking activities, shedding staff and restructuring.

Mario Draghi must wish that the ECB enjoyed the same powerful mandate as the Federal Reserve board. The Fed has enormous authority over the banks. It shares some of this authority with a plethora of federal and state agencies, but it is the central power. And, accordingly, it moved as fast as it could after the 2008/09 financial crisis to ensure that the banks recapitalised, deleveraged, restructured and consistently met high standards secured through Fed-managed stress tests. Further, the Fed has worked with the U.S. Treasury and other agencies to put in place the kind of bank resolution approach that makes future major government bank bailouts less likely.

The U.S. Federal Deposit Insurance Corporation, working with the Fed, has repeatedly found ways to ensure that depositors in weak and possibly failing banks could avoid losses. Mergers have been skillfully arranged. Costs have been shouldered over time by the banks. It is hard to imagine a viable euro zone resolution system absent similar arrangements.

Over the last two years, I have argued publicly that we are heading for dangerous times as the interest rate policies of the Fed and other key central banks, including the ECB of course, start to diverge. With the Fed's decision last month to raise interest rates, the era of divergence is now starkly upon us. This will inevitably pose added challenges to the euro's prospects, ones that will be all the harder because of the failure of Europe's leaders to create a strong banking union and grant the ECB the mandate that it requires.

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