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EUROPEAN ECONOMIC GOVERNANCE IN TIMES OF CRISES

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ABSTRACT

The international financial crisis was followed by the sovereign debt crisis in the euro area. This article discusses the main institutional and policy changes that have taken place in the European Union (EU) in response to these crises. It first examines the EU's response to the financial crisis, distinguishing between the short-term crisis management phase and the post-crisis reform of the framework for financial services regulation in the EU. Subsequently, the euro area's response to the sovereign debt crisis is discussed by examining the setting up of mechanisms of financial support to ailing countries, the tightening up of fiscal rules, and the establishment of Banking Union. The article argues that the lack of effective political leadership in the EU, the interlocking mechanisms of policy-making in the EU, and the different preferences of the member states have generated collective action problems in the reform of European economic governance. Hence, domestic political economy interests have often prevailed at the expense of effective collective euro area solutions. Overall, the EU's response has been reactive, belated and piecemeal. Several measures have been watered down during the complex EU negotiations. However, these often incremental changes, taken together, amount to a substantial reform of European economic governance.

Keywords: Economic and Monetary Union, Banking Union, Financial Regulation, European Union, Crises.
JEL codes: G21, G28, P16.

Introduction

The international financial crisis that reached its peak in late 2008 resulted in a fully-fledged economic crisis across much of the European

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Union (EU). Later it turned into a sovereign debt crisis in the euro area's periphery. In turn, the sovereign debt crisis risked creating a new banking crisis, threatening the very existence of the euro and menacing the global economy. These crises have pointed out a series of challenges concerning European economic governance. Specifically, the risks posed by globalised finance, coupled by regional (EU) financial regulation and mostly national supervision, at least prior to the setting up of Banking Union; the difficulties of international cooperation in crisis management, especially in the euro area; the asymmetric configuration of Economic and Monetary Union (EMU); the dangers of moral hazard in a single currency area, but also the drawbacks of misguided fiscal austerity.

These crucial issues have elicited belated and often disjointed institutional and policy changes in the EU, with a view to reducing the risk of future financial crises and preventing a potential domino effect of sovereign debt defaults. This article will first examine the causes of and the EU's response to the international financial crisis by distinguishing between the short-term crisis management phase and the medium-long term regulatory response. It will then discuss the causes of and the EU/euro area's response to the sovereign debt crisis by outlining the mechanisms of financial support set in place, the tightening up of fiscal rules and fiscal austerity, and finally the establishment of Banking Union.

1. The Playing Out of the International Financial Crisis in Europe and the EU's Response

The international financial crisis was caused by several interrelated factors. They can be summarised as: i) international macroeconomic imbalances, mainly between developed and emerging economies; ii) loose monetary policy in the United States (US) and the EU, boosted by capital inflows from Asia, and resulting in easy credit and 'irrational exuberance'; iii) lax financial regulation in the US and the EU and the growth of 'shadow' unregulated banking sector linked to regulated banks, coupled with a wrong 'incentive structures' (e.g. 'sub-prime' mortgages and 'predatory loans') and moral hazard, whereby banks privatised gains but socialised losses through public bail-outs. The international financial crisis also brought into sharp relief the interconnections between monetary policy, macroeconomic imbalances and financial stability.

The international financial crisis highlighted the 'disjuncture' between globalised financial markets, with intense financial market integration in the EU; EU and national regulation, which often resulted in regulatory patchworks (for example, the Capital Requirements directive (CRD) III had

more than 100 national discretions, which made cooperation during the crisis more cumbersome); and national systems of supervision, prior to Banking Union. This fragmentation of powers and responsibilities severely constrains the public authorities' ability to regulate and supervise financial entities and products in their jurisdictions. It also raises the problem of the under provision of the public good of financial stability (Nieto and Schinasi 2008), meaning that everybody benefits from financial stability, but the costs of providing it tend to be specific. Ultimately, this results in a collective action problem that applies worldwide, but is particularly acute in the EU, given its high level of economic and financial interconnections.

The crisis also highlighted the problem posed by ailing cross-border financial institutions, whereby the key political issue is the distribution of burden-sharing between the home and host countries and amongst host jurisdictions (Carmassi and Herring 2013; Kudrna 2012). Furthermore, host supervisors can exert only limited control on foreign banks operating in their jurisdictions, particularly when they take the legal form of branches (a point very much stressed in the Turner report 2009, which went as far as suggesting the compulsory transformation of branches into subsidiaries under specific circumstances). In the case of subsidiaries, which are separate legal entities in the countries in which they operate, key functions might well be centralised within the financial groups of which such subsidiaries are part, de facto limiting the power of the host country supervisors.

The short-term crisis management response of the EU to the international financial crisis was articulated on three fronts (Quaglia, Eastwood and Holmes 2008). First, the provision of liquidity through general liquidity injections of the European Central Bank (ECB) into the system, and liquidity injections of national central banks of the euro system to specific illiquid institutions. A similar course of action was followed by the central banks of EU member states outside the euro area. Second, there was bank recapitalization and restructuring, whereby the Eurogroup and the Ecofin Council adopted a concerted action plan to facilitate bank funding (government guarantees for new medium-term debt issuance) and recapitalization (government subscription of shares). However, the national plans adopted were not funded by a common fund, and were subject to EU competition rules and to the oversight of the Directorate General for Competition at the European Commission. Some cross-border cases of ailing banks were well managed (e.g. Dexia) other less so (Fortis proved to be very problematic, see Kudrna 2012). Third, on the fiscal side, the Ecofin Council and the European Council endorsed the Commission's recommendations for 1.5 per cent of EU GDP stimulus through budgetary expansion by the member states (around 1.2 per cent of EU GDP) and 'EU funding' for approximately 0.3 of GDP.

In the medium and long term, the EU's response to the international financial crisis was a host of new financial legislation (see Moloney 2010; Quaglia 2012). The vast majority of post-crisis EU legislation regulated activities or entities that were previously unregulated (or subject to self-regulation) in the EU and its member states (such as credit rating agencies, CRAs); or at the EU level (such as alternative investment fund managers (AIFMs)); or at the national, EU and international levels (such as over-the-counter derivatives (OTCDs)). In other instances, EU rules imposed heavier, more prescriptive and more burdensome requirements on financial entities that were already regulated prior to the crisis, as in the case of higher capital requirements for banks and new liquidity management rules (the CRD IV), or they set in place more substantial protection for depositors (the revised Deposit Guarantee Scheme Directive). Some of the post-crisis EU rules had potential protectionist effects due to the contentious provisions concerning the access of third-countries entities and products to the EU market, for example in the legislation concerning CRAs, AIFMs, OTCDs. The reform of the financial services architecture following the de Larosière Report (2009) was designed to strengthen financial supervision at the EU level and to foster macro-prudential supervision in the EU (Hennessy 2014). The sectoral committees of European financial supervisors in banking, securities markets and insurance were transformed into EU supervisory agencies.

By and large, the new or revised rules as well as the reshaped institutional framework were actively sponsored, or at least strongly supported, by France, Germany, Italy, Spain and the European Parliament (EP) (especially, the Socialist groups). The new EU measures were seen as necessary to safeguard financial stability and protect investors. Some of these, such as those concerning AIFMs, CRAs and OTCDs, also embodied the deeply ingrained Continental dislike of 'complex finance', which was seen as serving the fortunes of the City of London. The pace of reform was somewhat piecemeal in the EU - the pieces of EU legislation adopted post crisis constitute a series of incremental changes, rather than a path breaking reform. This has partly to do with the interlocking mechanisms of policy-making in the EU, where there are several veto players. Often, the member states had different preferences and worried about potential regulatory arbitrage with jurisdictions outside the EU. Lobbying from the financial industry, which was keen to limit the extent of regulatory change at the national, EU and international levels, in some cases, such as AIFMs and CRAs, watered down the proposed reforms. The changes carried out were those politically feasible given the compounded polity of the EU and the complex multi-level governance of financial services, rather than 'first best' solutions to the problems at hand (Quaglia 2012).

The regulatory response of the EU to the international financial crisis and the economic consequences of the crisis itself reduced the flow of credit to the real economy, in particular in continental Europe, where banks provide the bulk of funding to small and medium enterprises (SMEs) (Veron and Wolff 2015). In order to kick start again the economy and reduce the over reliance on bank intermediation, the Commission, with the support of certain member states, launched the project of Capital Markets Union (CMU). The project of CMU was fully in line with the 'Investment Plan for Europe' (aka the Juncker plan) of November 2014, which set out to remove obstacles to investment, providing funding and technical assistance to investment projects. According to the Commission, CMU would 'improve the financing of the economy… cut the cost of raising capital, notably for SMEs, and help reduce the very high dependence on bank funding. This would also increase the attractiveness of Europe as a place to invest' (European Commission 2015: 8).

The European Commission was the main policy entrepreneur on CMU, which was enthusiastically supported by the UK, joined by those member states with the most well-developed and diversified financial sectors, including Ireland, the Netherlands, Sweden and Luxembourg. These member states unequivocally supported the market liberalisation agenda in CMU. The main continental countries – notably France and Germany (Schäuble and Sapin 2015) – expressed their reservations on CMU and so did some of their domestic players (e.g. domestic banks and investment firms). By contrast, the most competitive parts of the financial industry, the main transnational players, such as large banks engaged in securitisation, insurance companies and the international financial centres in the EU, first and foremost the City of London, supported CMU (Quaglia, Howarth and Liebe 2016). The new measures designed to promote securitisation would benefits the large banks based in the UK, but also in France, Germany, the Benelux countries, Italy and Spain. Small banks would benefit from the new proposed legislation on securitisation, but the large banks would benefit the most, as they are the most engaged in shadow banking. The decision of the UK to leave the EU (the so-called Brexit) have casted doubts on the future of CMU, even though the EU's authorities have re-stated their intention to move forward with the project.

2. The building up of the sovereign debt crisis in the euro area

The euro area's sovereign debt crisis was a combination of the need to prop up domestic ailing banks, following the international financial crisis, especially in Ireland and later in Spain; a 'domestic' fiscal crisis, especially

in Greece, Portugal, and Italy, three countries with persistent pre-crisis fiscal deficit and debt problems; and a balance of payments crisis, which was caused by pre-crisis current account deficits and capital inflows, followed by sudden capital outflows during the crisis in the euro area periphery.

The international financial crisis had a 'differentiated' impact across the EU, which had mostly to do with the configuration of national financial systems across Europe (Hardie and Howarth 2013). Several governments intervened to rescue their ailing banks, but not all of them had sufficient fiscal margins of manoeuvre to do so. A 'doom loop' (Gros 2013; Veron 2012) was created between the instability of the banking sector – which had to be bailed out in the majority of euro area countries – and the fragility of public finances, which were becoming unsustainable in some countries. In Greece, the crisis took the form of a 'traditional' fiscal crisis, caused by persistent fiscal imbalances, mounting public deficits, and high public debt, mostly held abroad. The potential insolvency of these states threatened the stability of their banks, which held large amounts of sovereign debt. Moreover, the credit rating of banks was linked to the rating of their sovereign. In other countries, such as Spain and Ireland, the bailing out of national banks threatened the sustainability of public finance and the solvency of the state (Stiglitz 2016). This qualification is important in order to dispel the 'myth' of the euro area sovereign debt crisis as a fiscal crisis for all periphery countries. If the sovereign debt crisis is not to be seen as principally a fiscal crisis, then the EU's response based on austerity policies is not an effective solution. Austerity can actually worsen the crisis, with painful recessionary effects (Blyth 2013; Lapavitsas 2012).

The international financial crisis was an external shock to euro area financial stability, but the member states no longer had all the instruments to deal effectively with the crisis at the national level nor had these instruments been set up at the EU / euro area level. The establishment of EMU constrained both national support (bail-out) and resolution powers because of the budgetary limits imposed by the Stability and Growth Pact. Moreover, the introduction of the euro eliminated the possibility of monetary financing of sovereign debt. Finally, national supervision of large EU cross-border banks suffered from severe limitations, as explained above. The Financial Services Action Plan and the introduction of the euro substantially increased financial integration in the EU – especially cross-border banking in the euro area – but supervision, support and resolution remained at the national level.

For the euro periphery member states, the crisis was first and foremost a balance of payments crisis, due to the building up of persistent macroeconomic imbalances from the launch of the single currency in 1999. Indeed, the dangers related to the building up of macroeconomic imbalances due to different national competitiveness and the possibility of asymmetric

shocks were not addressed in the construction of EMU (Dyson 2000). Partly, this was because there was excessive confidence in the disciplining action of financial markets, whereas markets contributed to the imbalances that led to the crisis. In EMU, macroeconomic imbalances did not fade away: they were automatically financed only in so far as capital flew from countries with current account surpluses to countries with current account deficits, mostly through the intermediation of the banking system. Once these capital flows came to a halt (and, even worst, reversed) and the banking system in the EMU became balkanized, a de facto balance of payments crisis erupted. All the countries hit by the sovereign debt crisis had suffered major pre-crisis macroeconomic imbalances since joining EMU (Gros 2012a).

During the unfolding of the sovereign debt crisis but also in the debate on Banking Union, which was a way of dealing with the crisis by breaking the vicious link between the banks and their sovereign, the main line of division was between euro area countries directly hit by the crisis – namely Greece, Ireland, Portugal, Spain, Italy – and countries that were not directly affected by the crisis – namely Germany, Austria, the Netherlands and Finland – with France in-between. The first group of countries had balance of payments deficits, weak fiscal positions, and eventually needed external financial support, with the exception of Italy, which however benefitted from ECB interventions. The second group of countries had balance of payments surpluses, broadly sound fiscal positions, and were concerned about the risk of moral hazard in providing EU or euro area financial assistance during the crisis.

The sovereign debt crisis in the euro area involved two sets of moral hazards concerning, respectively, these two sets of countries, namely borrowers and lenders (Howarth and Quaglia 2016). On the one hand, there was the irresponsible behaviour of the euro area periphery, which for a decade took advantage of cheap credit and lenders who believed that bonds of periphery countries offered a 'risk free rate'. Unconditional EU / euro area financial support and / or debt restructuring would have provided the euro periphery hit by the crisis an incentive to engage in hazardous financial conduct in the future. On the other hand, there was the irresponsible behaviour of banks in so-called 'creditor' states in the run up to the 2008 crisis, which took no account of the borrowers' ability to repay the (cheap) loans they received (for example, Greece) and which caused credit bubbles (for example, Portugal) and real estate bubbles (for example, Spain and Ireland) in the euro area periphery. The EU's (piecemeal) intervention in the early stages of the sovereign debt crisis 'bought' time for international investors, including banks in core countries, to disinvest from the periphery, worsening the crisis.

However, there was also a 'hazard', even though perhaps not a 'moral' one, in doing nothing, which could threaten the very survival of the euro

(Stiglitz 2016), or in imposing debt restructuring, which could trigger chain reactions in the markets and contagion, transforming 'a local event into a systemic crisis' (Bini Smaghi 2013: 66). First, contagion could come from the collection of insurance purchased to protect against the effects of a restructuring (credit default swaps). Financial institutions that sold these securities would find themselves in difficulty. Second, market participants would question the ability of other euro area periphery countries in financial distress to repay their debt. Capital outflows to these countries would stop, driving up interest rates and further threatening debt sustainability. Indeed, whenever fears about the restructuring of Greek debt surfaced, interest rates on government bonds in all the periphery countries increased. Third, domestic banks that held large quantities of government bonds would find themselves suddenly undercapitalized as a result of debt restructuring (Bini Smaghi 2013).

Euro area member states responded to the sovereign debt crisis by promoting three main policy and institutional reforms designed to tackle the lacunae of EMU. However, the lack of political leadership in the EU and the collective action problems arising in the management of the euro area crisis meant that often domestic political economy interests prevailed at the expense of effective collective euro area solutions (Marsh 2013; Schimmelfennig 2015).The Commission, the French and euro periphery member states sought keenly to create European support mechanisms designed to purchase government debt to bring down national bond yields and ensure sustainable government borrowing, and potentially rescue banks. Spearheaded by the German government, a range of reforms was adopted to address the asymmetry between monetary and fiscal policies in EMU and, specifically, reinforce EU fiscal policy. Through Banking Union, euro area member states adopted a range of measures designed to break the sovereign debt-bank doom loop. They agreed to supranationalise banking supervision and resolution and create a European fiscal backstop to support struggling but solvent banks. The following sections provide a critical overview of each set of reforms.

3. Mechanisms for financial support to ailing countries

The creation of support mechanisms – notably the temporary European Financial Stability Facility (EFSF) first and subsequently the permanent European Stability Mechanism (ESM) – was the first EU's (euro area's) response to the sovereign debt crisis. However, it should also be seen in light of long-standing debates among EU member states and within the Commission on macro-economic policy support for member states. When

EMU was set up, many (especially the Germans) argued that balance of payments support became less essential on the grounds that sharing the same currency eliminated the potential for balance of payments problems (Dyson and Quaglia 2010). Consequently, the Maastricht Treaty limited the use of balance of payments loans that had been set up to deal with the balance of payments crises in the 1970s to non-euro area member states because balance of payments problems were no longer expected to occur in EMU. For this reason, Greece, which joined the single currency in 2001, was not eligible for the emergency financing offered to Hungary, Latvia and Romania (see Mabbett and Schelkle 2015).

In May 2010, euro area member states agreed to create the EFSF to provide funds specifically to euro area member states shut out from international bond markets and subject to EU adjustment programmes and additional conditionality – Greece, Ireland and Portugal (Gocaj and Meunier 2013; Salines *et al.* 2012). The EFSF was limited to 440 billion euros. To the Facility was added a Commission fund of up to 60 billion (the European Financial Support Mechanism (EFSM)) – which could be used to support all EU member states – and International Monetary Fund (IMF) support of up to 250 billion euros for a total of potentially 750 billion. The EFSM was an emergency funding programme for all EU member states in economic difficulty, subject to conditionality. Funds were raised on the financial markets by the European Commission and guaranteed by the EU budget. The EFSM essentially reproduced for the 27 EU member states the mechanism of the existing Balance of Payments Regulation for non-euro area member states.

The German government set the parameters of the EFSF: it was to be a purely intergovernmental body with decisions reached by consensus and a temporary mechanism to be liquidated in 2013. Member state contributions came in the form of credit guarantees for funds raised through the issue of bonds by a Luxembourg-based private limited company. The use of an intergovernmental agreement to create the EFSF allowed the member states to rely on a simplified domestic ratification process and to avoid having to guarantee EU operations on the financial markets. Anything resembling fiscal transfers or a fiscal union in the euro area would have been met by domestic opposition in Germany at the level of political elites and public opinion alike (Dyson 2014; Marsh 2013). Furthermore, the German government had to be constantly sensitive to the possibility of a legal challenge, given the past judgments of the German constitutional court as well as the cases pending before the court (De Witte 2011).

Following a bilateral Franco-German agreement, the EU member state governments agreed in October 2010 to create the permanent European Stability Mechanism (ESM) which was to replace the EFSF when the temporary mechanism was wound down. The decision to adopt an ESM treaty among

only euro area member states helped avoid a contradiction of the no-bail-out clauses in the EU treaties. The ESM was given authorised capital of 700 billion euros (but with only 80 billion in paid-in capital by the member states and the remainder to be lent through the issuance of bonds as under the EFSF) and a maximum lending capacity of 500 billion. Unlike the original EFSF, the ESM was given the power to recapitalise banks directly. Conditions would be attached, but unlike the stability support within a macroeconomic adjustment programme, the conditionality would focus only on the financial sector of the country in question (De Witte 2011; Victor 2010).

There were also options that were not chosen by the EU and its member states. First and foremost, the creation of 'euro bonds', which was presented by many as the quickest route to calming financial markets and bringing down bond yields (see, for example, several articles by Wolfgang Münchau, including *Financial Times* 13 November 2011). In November 2011, the European Commission produced a green paper on the creation of 'stability bonds' (Commission 2011). Supporters in France and Southern Europe argued that euro bonds would enable the euro area as a whole to borrow on the market at a better rate than the rates paid by periphery countries and hence the funds collected with euro bonds could then be invested in those countries. However, the proposal met with strong German opposition – stemming from a fear of moral hazard created for periphery countries – and was set aside by the Commission (Gocaj and Meunier 2013).

In opposition to the emphasis on fiscal policy reinforcement discussed in the following section, the French and euro periphery governments called for the creation and expansion of European support mechanisms which – it was argued – in addition to being a manifestation of much needed European solidarity, would help to calm financial markets. This position stemmed from longstanding views dating to the 1950s, that market integration and then monetary integration should be accompanied by support mechanisms that shared the burden of adjustment between surplus and deficit member states / strong currency and weak currency member states (Howarth and Quaglia 2013).

4. Fiscal rules and fiscal consolidation in the euro area and the EU

In parallel with the adoption of financial support mechanisms and arguably as a counter balance to them, a range of fiscal policy measures were adopted at the EU level since 2010 – the Six Pack, the Two Pack and the Treaty on Stability, Coordination and Governance (also known as the Fiscal Compact). However, these measures correspond largely to previous agreements on fiscal policy at the EU level in the sense that they continue

to allow member states considerable margin of manoeuvre. They provide a questionable reinforcement of pre-existing EU and national fiscal rules. Fiscal policy reforms reflected the German position that responsibility for resolving the sovereign debt crisis ultimately rested with the individual member states themselves and the achievement of sustainable fiscal policies (Chang 2013; Schoeller 2017). This position stemmed from longstanding German insistence upon necessary macroeconomic policy convergence (low inflation and low public sector debt loads) in order to ensure a stable EMU (Dyson and Featherstone 1999).

From 2009, the adoption of new EU fiscal rules, including the Fiscal compact and its transposition into national legislation, came at German insistence, with the debt rule of the Fiscal Compact a marginally more flexible version of the German variant, the Schuldenbremse (Fabbrini 2013). The treaty required all governments to adopt national legislation introducing a rule that general government budgets were to be 'balance' or in surplus. A fine could be imposed on member states that failed to do so. National laws were to contain supposedly 'automatic' correction mechanisms, but national governments could determine the trigger to these mechanisms as long as the existing guidelines of the Six Pack provisions were respected. Exceptional circumstances could still be considered to block temporarily the mechanism – undermining its automaticity (Gros 2012).

The Six Pack and Two Pack were two packages of legislative measures, proposed respectively by the Commission in 2010 and 2011 and agreed by the Council in 2011 and 2013. They were designed ostensibly to reinforce the Commission's fiscal policy surveillance. While marginally more restrictive of national policy making (for example, the introduction of the European semester into national budgetary cycles involving earlier Commission intervention), most academic observers have queried the extent to which these measures restrict national fiscal policy margin of manoeuvre (see, for example, Marzinotto and Sapir 2012). The actual impact of the intergovernmental Fiscal Compact was likely to be limited and amounted to only modest modifications of the existing SGP and the measures already agreed in the Six and Two Pack reforms (Gros 2012).

5. The establishment of Banking Union [1]

In June 2012, the President of the European Council, the President of the Eurogroup, the President of the Commission and the President of the

[1] This section partly draws on Howarth and Quaglia (2016). I wish to thanks David for having allowed me to use parts of our joint work.

ECB, presented an interim report titled 'Towards a Genuine Economic and Monetary Union'. The Van Rompuy (2012) report, which was also known as the Four Presidents Report, proposed what later became known as Banking Union, namely 'an integrated financial framework to ensure financial stability in particular in the euro area and minimise the cost of bank failures to European citizens. Such a framework elevates responsibility for supervision to the European level, and provides for common mechanisms to resolve banks and guarantee customer deposits'.

The project of Banking Union was subsequently endorsed by the European Council and euro area summit in June 2012. The main objective of Banking Union was to break the 'vicious circle' between ailing banks and struggling sovereigns by providing financial assistance to countries and banks hit by the crisis. The instruments to do this were to shift banking supervision and resolution to the Banking Union level, and to introduce new EU rules for the resolution of ailing banks and the protection of depositors (this component of Banking Union was subsequently set aside, as explained below). Banking Union was to include all the countries in the euro area as well as the countries that decided and were able to opt-in.

Banking Union was intended to address the 'financial trilemma' identified by Dirk Schoenmaker (2013) and consisting of financial stability, international banking and national financial policies. In the trilemma, any two of the three objectives can be combined but not all them: one has to give. The single currency made the trilemma more acute in the euro area not only by increasing cross-border banking in the euro area, but also undermining national financial policies, because the function of lender of last resort can no longer be performed by the national authorities. Furthermore, national resolution powers are limited by fiscal rules in the euro area. Consequently, the safeguard of financial stability can only be achieved at the euro area level (Howarth and Quaglia 2016).

Banking Union was proposed in June 2012 to tackle the sovereign debt-bank doom loop that arose in the context of the sovereign debt crisis because of the flight of foreign investors from euro periphery member states. Banks headquartered in these countries came to hold an increasing amount of debt issued by government – measured both as a percentage of total debt issued and as a percentage of total bank assets. The threat of default on this debt undermined confidence in the solvency of a number of euro periphery banks, including some that had escaped the crisis largely unscathed. Confidence in the solvency of euro periphery governments, already facing a heavy and rising debt burden, was further undermined at the prospect of further bank bail-outs (Howarth and Quaglia 2016).

For these reasons, euro area member state governments agreed (in some cases with great reluctance) to set up Banking Union, which shifts

policies for supervision and resolution from the national level to the Banking Union level. The UK, which was not part of the single currency and had a very internationalized rather than 'Europeanised' banking system, lacked an incentive to join Banking Union. Central and Eastern European member states of the EU that had banking systems dominated by foreign (mostly euro area) owned banks had an incentive to join Banking Union because they were not in a position to safeguard financial stability domestically (Spendzharova 2014). The euro area countries that faced the trilemma had however different preferences on the various elements of Banking Union, depending on the concern of national policy-makers for moral hazard and the configuration of their national financial systems. Hence, the negotiations of certain components of Banking Union were time consuming (see De Rynck 2016; Donnelly 2014; Epstein and Rhodes 2016) and a 'light' version of Banking Union was agreed in the end, as explained below.

The main supporters of Banking Union were the French, Italian and Spanish governments, which pointed out the need to move quickly (Epstein and Rhodes 2014). By contrast, the German authorities argued that timing was not the essence and that it was instead important to get the right institutional arrangements in place (Schaffer 2016). The UK by and large supported the Banking Union project, but declared at the outset that it would not be part of it. The British authorities were however concerned about the 'side effects' of Banking Union, such as the potential formation of a euro area majority influencing EU financial regulation *tout court* (Ferran 2015; Schimmelfennig 2016). The financial industry broadly supported Banking Union, although there were some important disagreements on the specific components of Banking Union, as suggested for example, by the statements and position papers issued by the British Bankers Association (2012), the Association of German private Banks and (2013) and the French Banking Association (2012).

One after the other the main component of Banking Union were set up, with the exception of the European Deposit Insurance Scheme (EDIS). The Single Supervisory Mechanism was agreed in October 2013: it assigned the responsibility for banking supervision to the ECB (Ferran and Babis 2013; Kern 2015). To be precise, the final agreement reached at the December 2012 European Council foresaw that the ECB would be 'responsible for the overall effective functioning of the SSM' and would have 'direct oversight of the euro area banks'. This supervision, however, would be 'differentiated' and the ECB would carry it out in 'close cooperation with national supervisory authorities'. The regulation establishing the SSM also permitted the ECB to step in, if necessary, and supervise any of the 6000 banks in the euro area to bring about the eventual restructuring or closure of ailing banks.

In March 2014, an agreement was reached on the establishment of the Single Resolution Mechanism (SRM). It was agreed that the ECB would be responsible for deciding whether or not a bank should be resolved, but the SRM Board could take this decision should the ECB decline to do so. The main decision-making power to enter a bank into resolution, the application of resolution tools and the use of the SRF was assigned to the SRM Board, mainly composed of national authorities. The Board would be responsible for the planning and resolution phases of cross-border banks and those directly supervised by the ECB, while national resolution authorities would be responsible for all other banks, as advocated by Germany. The SRF, financed by bank levies raised at national level, would initially consist of national compartments that would be gradually merged over eight years (Kern 2015).

The missing component of Banking Union was the EDIS. In June 2012, the interim Van Rompuy (Four Presidents) report mentioned the need to set up a EDIS. However, the final Van Rompuy report issued in December 2012 only made reference to the 'Agreement on the harmonisation of national resolution and deposit guarantee frameworks, ensuring appropriate funding from the financial industry' (Van Rompuy 2012, p. 4). In other words, by December 2012, any reference to the setting up of a EDIS had disappeared from the agenda for Banking Union, mainly because of German opposition (*Financial Times*, 12 September 2012). By contrast, France and other periphery countries supported a EDIS. However, they focused their efforts on the SRM, rather than lobbying for a EDIS, which was seen as a lost battle. The ECB regarded the EDIS as an important component of Banking Union, but that could be implemented later on (Constacio 2014). Furthermore, the different configuration of existing national DGS, which in turn were linked to the different configuration of national banking systems, would have made full harmonization extremely complex.

The Banking Union that was eventually agreed and subsequently set up between late 2012 and mid 2014, was somewhat a 'lighter' version of that initially proposed in June 2012 in two main respects. First, member states governments retained their vetoes on the mutualization on national fund and an important say on the use of resolution funds in the SRM. Moreover, a rather 'complex' compromise was reached on triggering the resolution process. Second, a EDIS was not set up and the idea was shelved for the time being. The Banking Union light was eventually agreed at the insistence of Germany (Donnelly 2014), whose main concern in the setting up of Banking Union was to avoid moral hazard, that is not to provide incentives for 'risky' behaviour of sovereigns and banks. Indeed, Germany is the largest economy in the euro area, it has a large current account surplus and a sound fiscal position. Thus, it would be the main net contributor to the support and resolution mechanisms of Banking Union. Germany enjoyed

a kind of veto power in the construction of Banking Union (Bulmer and Patterson 2013), although one constrained by the threat of sovereign debt default in the euro periphery, contagion and euro area disintegration.

Interestingly, a similar debate had unfolded when EMU was agreed in 1992. During the negotiations leading to the Maastricht Treaty (Dyson and Featherstone 1999), some member states, first and foremost Germany, opposed fiscal (or transfer) union for political and economic reasons. Politically, it was seen as a step too far, impinging upon a core area of national sovereignty. Economically, member states with sound fiscal positions, led by Germany, were concerned by the potential moral hazard that a fiscal union would bring about, and that they would end up financing countries that lacked sufficient fiscal discipline (for an overview of this debate, see Dyson and Quaglia 2010).The result was an asymmetric EMU, whereby monetary union was not coupled by a full economic (fiscal) union (Dyson 2000, Verdun 1996). Banking Union was an attempt to 'complete' EMU, but even Banking Union was incomplete, without a fiscal backstop and a European Deposit Insurance Scheme.

6. Conclusion

This work has examined the main causes of the problems that have plagued European economic governance over the last decade, following the international financial crisis and the sovereign debt crisis in the euro area. It has also examined the delayed and sometime inadequate response of the EU to these crises, as well as the political dynamics underpinning the economic measures adopted (or, in certain cases, such as Euro bonds, or the EDIS, not adopted). The wave of post crisis EU regulatory measures that were designed to secure financial stability have somewhat fell short of the expectations and arguably of what was needed to secure stability in the future. The response to the sovereign debt crisis has been reactive, and sometimes misguided (e.g. some of the policies implemented by the Troika in the countries that received EU financial support, see Stiglitz 2016). The institutional and policy reforms implemented have sometimes pulled in different directions, in an attempt to counter balance each other (e.g. financial support to ailing countries and fiscal austerity). Other times, the EU measures eventually enacted fell short of what was initially envisaged, at least by some (e.g. the use of ESM to directly recapitalise banks, the establishment of the EDIS). This was also a manifestation of different preferences of the member states. In this respect, Germany was often a veto player, opposing or watering down reforms, as in the case of euro bonds and Banking Union, respectively.

Banking Union, which is perhaps the most important innovation in European economic governance since the introduction of the euro, will increase the trend towards differentiated integration in the EU, to be precise the divide between the euro area and non euro are member states in the EU. Even more challenging for the EU and the UK is the process of Brexit and potential centrifugal tendencies in other member states of the EU, fuelled by mounting Euroscepticism. In turn, the latter is partly the consequence of the poor performance of the EU in dealing with the crises and the limited ability to reform itself substantially. In part, politically, Euroscepticism is the result of blame-shifting towards the EU by national political elites, which have to deal with disaffected domestic public opinion in both creditor and debtor states.

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