10

Banking Union

The personalities of European Central Bank (ECB) presidents Jean-Claude Trichet and Mario Draghi could not have been more different, at least in the ways they conducted themselves in Ecofin meetings. Trichet craved the spotlight. He was very active at the beginning of each meeting when the media were invited in to take pictures. Then he would read prepared statements, and after that he would fade into the role of passive observer. Often, he would leave the meeting within an hour or two of its opening. By contrast, his successor, Draghi, avoided the cameras, scribbled his talking points on bits of paper a few minutes before the meeting began, tossed out comments throughout the discussions, and stayed until the end—which was frequently in the wee hours of the morning.

I was able to observe the participation of both men at close range. In Ecofin meetings, we sat in alphabetical order by member country name. European Union institutions were assigned seats on the two short sides of the table. And so my neighbors were always the same: To my left was Jürgen Ligi, the Estonian finance minister, and to my right was Josef Pröll, and then his successor, Maria Fekter, the Austrian finance minister. To her right sat the president of the ECB, first Trichet and then, as of 2011, Draghi. At coffee breaks, we sometimes exchanged views, especially when Draghi came on board.

The differences in the personalities of Trichet and Draghi may explain their behavior when at the helm of the ECB. Trichet's methodical, cautious approach precluded quick decisions to address market sentiment. Draghi's more instinctive approach allowed decisive actions to tame the animal spirits of the financial markets. Overall, Draghi's approach seemed better suited for the euro crisis, especially in view of the indecisiveness of the president of the European Commission, Manuel Barroso.

Draghi Takes the Helm

Personality differences were likely also the reason the banking union began to take shape under Draghi's leadership. The idea was not new: In 2010 Germany had wanted the ECB to take on the role of single banking supervisor for the eurozone. The logic was that the euro deepened financial interdependence in Europe and so required integrated supervision. In fact, had such integrated supervision been applied earlier, it might have prevented the buildup of large private financial imbalances in some eurozone countries from 1999 to 2009. With Draghi at the helm of the ECB, the key eurozone politicians—in Berlin, Luxembourg, the Hague, and Paris—were confident that a banking union would finally emerge.

"The ECB's evolution to lender of last resort has blunted market pressure and political momentum," observed a eurozone analyst in May 2013.[1] Indeed, the euphoria surrounding the last days of December 2012 when European Commission president Barroso had outlined an ambitious program for centralized fiscal control in Brussels had quickly subsided. By late January 2013, European politicians were relying on the ECB to pull Europe out of the crisis.

Draghi's announcement in mid-2012 of unlimited liquidity reduced borrowing costs across the southern rim, especially in Italy and Spain. This development in turn allowed Spanish prime minister Mariano Rajoy to avoid a comprehensive aid package and instead focus on assistance for the Spanish banking sector. And it saved Italian prime minister Mario Monti's reputation. His government would likely go down in history as the one that brought Italy back from the brink of collapse. But in truth, the ECB deserved the most credit. Most of the Monti government initiatives died out in the Italian Parliament. And some did not even reach it.

By being decisive when everyone else was waffling, the ECB became Europe's most trusted institution. That reputation was quite different from the one the bank had early in the crisis under Trichet. Then, the ECB did not appear to be doing enough. In response to the global financial crisis that erupted in 2008, the ECB introduced liquidity support to banks in November of that year. That was the only measure taken by the ECB before the sovereign debt crisis blanketed Europe. One result of full allotment was that some of the banks addicted to ECB credit emerged (Eijffinger and Hoogduin 2012).

As noted earlier, the new leadership at the bank and the personalities that went with it made a big difference as well. Trichet had a roundabout way of saying things and would take cautious positions. He often looked tired and showed no resolve. Vítor Constâncio, vice president of the ECB since 2010, usually accompanied Trichet to Ecofin meetings, but he was not a straight talker either. When the new president, Mario Draghi, and Jörg Asmussen, a member of the Executive Board, took over, the atmosphere and energy in Ecofin shifted. Both men were sharp, tireless, and confident. Although much

1. Peter Spiegel, "Integration Put on Back Burner," *Financial Times,* May 9, 2013.

credit goes to Draghi, in Ecofin the more trusted figure was Asmussen. We had worked together earlier in his capacity as deputy finance minister. He was outspoken then, and he remained so in his new position as a member of the ECB's Governing Council. At Ecofin meetings, he never hesitated to give his opinion on difficult issues. But, more important, he had one quality few central bankers have—he was a genuinely likeable person. He knew everyone by name, and during coffee breaks and informal meetings, he was willing to talk to anyone. By contrast, during the Trichet era, the ECB representatives would stick together, or they would talk to French finance minister Christine Lagarde or German finance minister Wolfgang Schäuble, or to whoever was being followed by journalists' cameras. I doubt Trichet knew more than a quarter of the EU finance ministers by name. All these differences made an impression on incoming finance ministers, not just on me.

ECB Takes Center Stage

In 2010 resolving the euro crisis seemed a matter for the governments of the eurozone. At the outset of the Greek debt crisis, the ECB identified the underlying cause as excessive deficits and debts. But Trichet was also aware that no immediate remedy was available at the government level. The emergency fund, the European Financial Stability Facility, would not begin operations until much later, and it was going to take time to negotiate an EU-IMF program for Greece.

The creators of the eurozone had paid no attention to banking issues, and especially to the importance of national as opposed to EU-wide guarantees in the eurozone. In Europe, bank bailouts had caused sudden jumps in government debt, most notably in Ireland, where the government's assumption of bank debts abruptly added 40 points to the ratio of public debt to GDP. Belgium, Cyprus, the Netherlands, and Slovenia experienced such troubles as well.

The ECB Governing Council found itself in uncharted territory. It had to decide whether and how to intervene in government debt markets. This was no ordinary monetary policy decision. The fact that intervention intended to calm market turbulence could have been an argument for grounding it in financial stability considerations. But this was not in the ECB's mandate, and for that reason Trichet was indecisive.

Peter Praet, a member of the Executive Board of the ECB, explained the quandary in an April 2013 speech: "The standard monetary policy action was judged as insufficient because, during the crisis and especially from 2010 the interest rate channel of the monetary policy transmission mechanism was impaired. . . . In response to this challenge, the ECB engaged in a series of nonstandard measures to restore a proper transmission of the monetary policy impulses, including lending operations through a fixed rate tender procedure with full allotment, the provision of liquidity with longer maturity and an expansion of the set of assets that could serve as collateral for receiving central bank liquidity."[2]

As a further step, the ECB began to intervene directly in securities markets in order to correct the malfunctioning of certain segments. The first action of this type was the Securities Markets Programme launched in May 2010. The ECB argued that the program, which began to buy government debt in the secondary market, was intended to facilitate the homogeneous transmission of monetary policy.

In June 2010, Trichet told Ecofin that the Securities Markets Programme would be temporary. But as the crisis evolved, the program remained open. Governments did not take sufficient measures to end the market turbulence or to make it possible for the ECB to (gradually) exit the program. Early in the spring of 2011, tensions in the markets did lessen, and the size of the Securities Markets Programme stabilized at €70 billion to €75 billion ($97 billion to $104 billion). It began to look as though the program would die quietly, but then the crisis flared up again when Spain, and later Italy, came under pressure. The result was a very rapid increase in the size of the program to well above €200 billion ($277 billion).

The Securities Markets Programme strained relations between the southern rim governments and the ECB. Trichet became increasingly annoyed with those governments for not taking measures that would go to the root of the crisis. In fact, the ECB had to write governments to force them to take consolidation measures and implement structural reforms as a condition for eventually purchasing bonds. Trichet was clearly upset that politicians were turning more and more for solutions to the ECB. He wanted to run the institution as a conservative central bank and not burden it with unnatural responsibilities akin to expansionary fiscal policy.

When problems mounted again toward the end of 2011, there was resistance in the ECB Governing Council to accelerating purchases of government bonds under the Securities Markets Programme. The new president of the Bundesbank, Jens Weidmann, argued that this would not be compatible with the treaty creating the European Union. Draghi made the point to the Governing Council that governments first had to adopt the Fiscal Compact, which would minimize the risk of similar problems in the future. This was Trichet's view as well at the December 2011 Ecofin.[3]

After Ecofin announced the negotiations on the Fiscal Compact, the majority of the ECB Governing Council looked more favorably on taking additional action in the bond markets.[4] However, resistance by some council

2. Peter Praet, speech at the colloquium "The Challenges Ahead," Pioneer Investments' Colloquia Series "Redrawing the Map: New Risk, New Reward," Unicredit, Beijing, April 17, 2013.

3. Mario Draghi, "The Euro, Monetary Policy and the Design of a Fiscal Compact," Ludwig Erhard Lecture, Berlin, December 15, 2011.

4. Mario Draghi, "Remarks at the Annual Reception of the Association of German Banks," Berlin, March 26, 2012.

members against further increasing the Securities Markets Programme had not disappeared. In Germany, there was strong, broad opposition outside the Bundesbank to the program.

As uncertainty kept building after a quiet summer, the ECB took action. In October 2011, Trichet announced two long-term refinancing operations with three-year maturity. The ECB also allowed seven national central banks to accept a wider range of collateral against its refinancing operations. These combined measures led to an injection of liquidity in the European banking sector of over €1 trillion ($1.4 trillion).

At first, it was unclear why the ECB announced two long-term refinancing operations. And why it did choose maturity of three years and not of one? Also, why did the ECB not introduce a cap to remain in control of its own balance sheet? The rapidly worsening market situation at the time provided the answers: The ECB wanted to stop once and for all any speculation that it would not defend the European banking sector. Its action had just put a premium on maturities that were longer than the market had become used to. Eventually, market turbulence disappeared, and the risk premia of Spain and Italy came down. More generally, the eurozone entered a period of relative calm.

Because refinancing operations had been undertaken successfully elsewhere, Draghi was able to benefit from that experience when he took office on November 4, 2011. Both the US Federal Reserve and the Bank of England had created large asset purchase programs. The Fed bought assets to increase the overall expansionary stance of monetary policy and to turn around the reduced flow of credit to housing markets. The Bank of England was also buying assets in an attempt to improve the flow of credit to businesses. As Draghi explained, "What we saw is that after the first [longer-term refinancing operation] the senior unsecured bond market reopened. In the last two months we had something like €40 billion of new issuance, which is about as much as it was in the previous six months or more. We also saw €30 billion in new covered bond issuance. But for the interbank markets to function we need a return of full confidence in the counterparty. We can address only the liquidity side of the problem. But then growth prospects have to pick up."[5]

By acting decisively, the ECB reduced pressure on eurozone governments to increase their emergency funds. An alternative would have been a further increase in the Securities Markets Programme. The program was addressing the problem of sovereign debt at its roots without involving the banking system and without causing the related spillover effects. But that approach was judged to be an insufficient signal to markets.

On December 21, 2012, Draghi announced the results of the ECB's intervention: Troubled banks had received €490 billion ($679 billion) as part of the program. In the weeks that followed, the banks used a sizable share of the cash

5. Brian Blackstone, Matthew Karnitschnig, and Robert Thomson, "Q&A: ECB President Mario Draghi," *Wall Street Journal*, February 23, 2012.

to buy the European bonds so desperately in need of customers. It was as if the ECB had injected lenders with infinite liquidity and then asked them to flood the markets.

This determination was applauded by Adam Posen, at the time a member of the Bank of England's monetary policy committee. A scholar on what is often called Japan's lost growth, he argued that the US Federal Reserve and the ECB were making the same monetary policy mistakes that left Japan's economy stagnant for two decades starting in 1990. "The Austrians would say you just have to suffer through it," Posen was quoted as saying, referring to a school of economic thought popularized by Friedrich Hayek and Ludwig von Mises. "But suffering is not good for the soul—monetary policy won't solve all your problems, but it can make things easier."[6]

Under its previous president, Trichet, the ECB had long resisted more aggressive action, unwilling to saturate the market with money (the way the Fed did in 2008) until governments committed to reining in spending and deregulating their economies. According to Jacob Kirkegaard, a research fellow at the Peterson Institute for International Economics in Washington, "By refusing to act decisively at an early stage, they in a sense perpetuated the crisis, creating a situation where in the end the euro-area politicians had no other choice than to do the right thing."[7]

In the meantime, market sentiment shifted again after the summer of 2012, and stability evaporated. On September 6, 2012, the ECB announced it would be undertaking an Outright Monetary Transactions (OMT) program in secondary markets for sovereign bonds in the eurozone. This was the "whatever it takes to preserve the euro" that ECB president Mario Draghi had promised on July 26. Back then, at the Global Investment Conference in London, Draghi had remarked: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."[8] As noted in chapter 9, this was the fifth tipping point in the euro crisis.

The OMT program called for interventions in government bonds whose remaining maturity was up to three years. It required the governments to accept an arrangement involving support by the European Stability Mechanism (ESM), but stiff conditions would be applied. Such conditions were important to preserve monetary policy independence. Interventions would be ex ante unlimited, which was essential to ensure their effectiveness. They also would be sterilized to ensure that these measures would have no effect on the overall monetary policy stance. Finally, there would be transparency because the stock

6. Landon Thomas, "From an American in London, Global Warnings," *New York Times*, September 17, 2011.

7. Quoted in Nicholas Kulish, "Central Bank Becomes an Unlikely Hero in Euro Crisis," *New York Times,* January 20, 2012.

8. Mario Draghi, speech at the Global Investment Conference, London, July 26, 2012.

of securities acquired under the OMT program would be published regularly, together with the average duration.

Draghi Calls for Structural Reforms

Draghi's tactics worked for six months, until the Cyprus crisis erupted. On March 14, 2013, during a meeting of the European Council, Draghi made a presentation to the heads of state and government on the economic situation in the eurozone. His intent was to lay out the reasons for the crisis. He presented two graphs that showed that productivity growth in the surplus countries (Austria, Belgium, Germany, Luxembourg, and the Netherlands) was higher than in the deficit countries (France, Greece, Ireland, Italy, Portugal, and Spain). But wage growth was much faster in the latter group. The lesson: Structural reforms and wage moderation are the keys to success.

Instead, the southern rim heads of state asked the ECB for funding for their real economies—that is, the part of their economies actually producing goods and services. In addressing this request, the ECB could have emulated the Bank of England's scheme in which the access of banks to central bank credit was contingent on how much they then lent to the real economy. The Bank of England's program, introduced in June 2012, allowed banks to borrow up to 5 percent of their existing lending stock at funding costs well below market rates for even the strongest institutions.

The bank's scheme was not a total success, however.[9] It had cut about a percentage point off the deposit rates banks were offering. And there was no boom in lending. In fact, UK credit availability probably would have contracted significantly without the Bank of England's scheme. And that was enough of an incentive for the ECB to push credit into Europe's struggling economies.

A broader proposal, following the call for greater involvement by the ECB, was for the ECB to expand its focus from inflation targeting to output targeting. This notion was supported by French president François Hollande and some of the heads of state of the southern rim countries. Among the measures proposed for macroeconomic supervision by the ECB was a system of progressive reserves on bank loans based on the sector and on the supervision of individual banks. A sector-based reserve requirement could channel funds to those sectors considered important for economic development. Adjusting the reserve requirements to individual banks would make them better match each bank's situation (Richter and Wahl 2011).

The German position, however, was that the ECB should retain its narrow mandate. As Jens Weidmann, the head of the Bundesbank, told Reuters in March 2013, "We must be careful not to further blur the borders between monetary and fiscal policy."[10]

---

9. Alen Mattich, "BOE Offers Lending Template to ECB," *Wall Street Journal*, April 8, 2013.

10. Reuters, Eva Kuehnen and Paul Carrel, "Euro Woes Not Over, Says Crisis-Wary Bundesbank," March 12, 2013.

ECB: Eurozone's Banking Supervisor?

One idea that Germany did like was assigning the role of single eurozone banking supervisor to the ECB. Such a move was also consistent with the prevailing model in European countries of entrusting banking supervision to the central bank. For that reason, the EU treaty had included the possibility of giving supervisory powers to the ECB.

This thinking had its roots in the earliest days of the eurozone. In 1999 Tommaso Padoa-Schioppa, a member of the first ECB board responsible for financial stability, wrote: "I am convinced that in the future the needs will change and the multilateral mode will have to deepen substantially. Over time such a mode will have to be structured to the point of providing the banking industry with a true and effective collective euro area supervisor. It will have to be enhanced to the full extent required for banking supervision in the euro area to be as prompt and effective as it is within a single nation."[11]

The eurozone single banking supervisor is one of several components of a functioning banking union. In a speech at Chatham House in March 2013, Vítor Constâncio, vice president of the ECB, listed the components: (1) a single rulebook for banks; (2) a single framework for banking supervision; (3) a single mechanism for dealing with troubled banks funded by levies on the sector itself; (4) a common backstop in case temporary fiscal support is needed; and (5) a common system for deposit protection.[12]

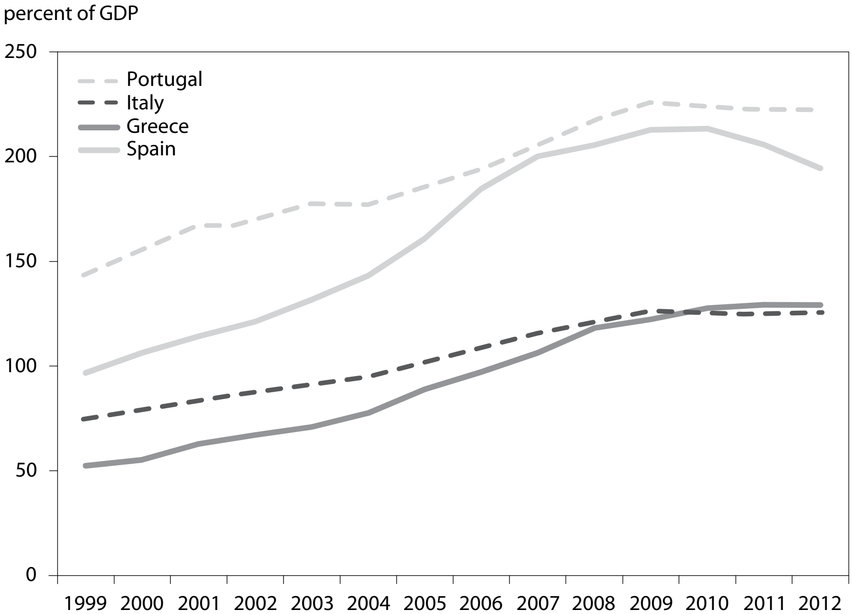
I take the view that a banking union could have prevented the buildup of large private financial imbalances in some eurozone countries from 1999 to 2009 (figure 10.1)—the increase in private borrowing was made possible by declining interest rates as a result of the monetary union. In fact, the largest imbalances were concentrated in lending to private business. Between 1999 and 2008, the ratio of public sector debt to GDP in the eurozone declined on average by about 6 percentage points, while the ratio of private sector debt to GDP increased by 28 percentage points. At the extreme, in Spain the ratio of private sector debt to GDP increased by about 75 percent, while the ratio of public debt to GDP fell by 35 percent (figure 10.2).

A banking union would also eliminate the so-called bank-sovereign loop that endangered the fiscal sustainability of countries, most recently Cyprus and earlier Ireland and Spain. This vicious cycle was driven by the expectation that governments would have to bail out struggling banks. A Single Resolution Mechanism, the third component of a full banking union as described by Constâncio, would avoid these increases by dealing with troubled banks rather than saving them and by having the private sector instead of the taxpayer pick

11. Tommaso Padoa-Schioppa, "EMU and Banking Supervision," lecture at the London School of Economics, February 24, 1999.

12. Vítor Constâncio, speech at the conference "Financial Regulation: Towards a Global Regulatory Framework?" Chatham House City Series, London, March 11, 2013.

Figure 10.1 Private debt in Portugal, Italy, Greece, and Spain, 1999–2012



Source: Eurostat, http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database (accessed on February 29, 2014).

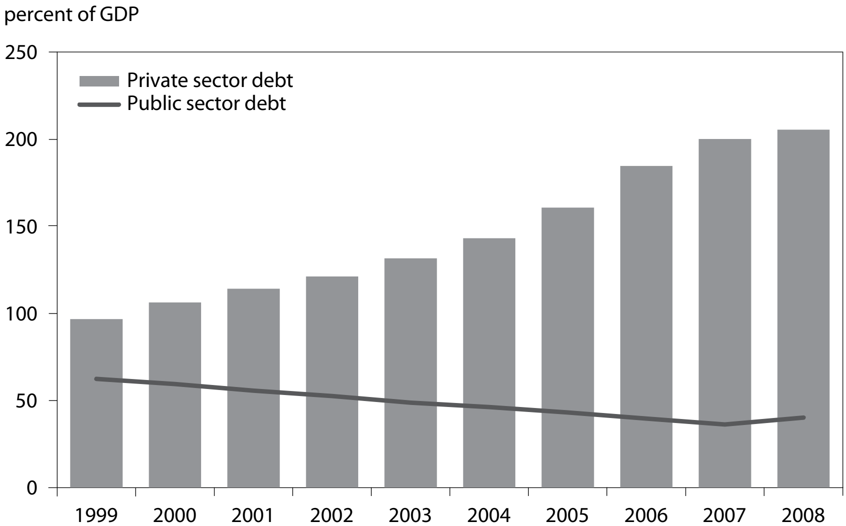
up the bill. Moreover, the residual fiscal burden would be on the eurozone through the ESM.

Finally, a banking union would limit financial fragmentation in the eurozone. A single banking supervisor conducting credible stress tests would erase fears that banks are hiding bad assets in some countries. Depositors' confidence would grow by harmonizing deposit guarantee schemes, thereby discouraging Europeans from moving money from one bank to another based on their beliefs about the soundness of national supervision. This was a point made consistently by Schäuble as a main benefit of a banking union.

By early 2013, some progress had already been made on a banking union. For example, a single rulebook for banks was in place. The creation of a common backstop was already under way as well, with the possibility of direct bank recapitalization by the ESM. This was something on which Eurogroup president Jean-Claude Juncker had insisted. Work on a single mechanism for resolving banks and a common deposit guarantee scheme was still in the early stages, however.

The surprise levy on Cypriot bank deposits as part of the country's bailout in March 2013 gave an additional boost to the belief that Europe should be united in tackling bank problems. "The deeply distressing problems faced by

Figure 10.2 Public versus private sector debt in Spain, 1999–2008



Source: Eurostat, http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database (accessed on February 27, 2014).

Cyprus show how insufficient this bailout step is in itself," said Martin Schulz, the German president of the European Parliament, calling for an EU-wide scheme to close failing banks and guarantee deposits.[13]

Sixth Tipping Point

In considering a banking union, Ecofin had made the most progress in putting in place a single banking supervisor. On December 14, 2012, Ecofin approved the appointment of such a supervisor, and the decision was confirmed by the heads of state immediately. This, the sixth tipping point in the eurozone crisis, wiped out any remaining doubts that European politicians were really united in strengthening the euro. The reform required governments to yield control over the supervision of national banks to the ECB in April 2014, or one year after the legislation entered into force after adoption by the European Parliament, whichever came later. And yet Sweden, the United Kingdom, and other non-euro-area countries had safeguards in place to check the power of the ECB and to maintain some influence over the technical standards applied to all EU banks.

13. John O'Donnell and Claire Davenport, "ECB Wins Watchdog Role under Cloud over Cyprus Deposit Levy," Reuters, March 19, 2013.

In its new role, the ECB would have direct responsibility for banks with assets of more than €30 billion ($42 billion) or those representing more than a fifth of a state's national output. This definition covered about 150 banks. Another rule called for every eurozone country to have at least three banks directly supervised from Frankfurt, where the ECB had its headquarters. However, the ECB retained the power to intervene in any bank and deliver instructions to national supervisors. Malta's finance minister, Tonio Fenech, objected to the three-bank rule, arguing that virtually the whole banking sector of Malta would be supervised by the ECB. Some other small countries such as Lithuania made the same point. In the end, Malta was exempted from the rule with a special clause.

The much-discussed cutoff of €30 billion made sense. Although the eurozone had over 6,000 banks (much like the United States), the 150 largest banks covered 80 percent of banking system assets. For the rest, delegating them to national authorities was both necessary and useful. Schäuble was particularly animated in all the discussions about the need for a cutoff. Otherwise, the new authority would simply be clogged with work and quickly labeled ineffective. Jürgen Ligi, the Estonian finance minister, supported the same view.

The ECB was also given the task of creating a board of supervisors, made up of one bank supervisor from each supervised country. This board would make decisions on bank supervision that could be vetoed or approved, but not changed, by the ECB Governing Council. The Governing Council, made up of the central bank governors of the eurozone member countries and members of the ECB Executive Board, sets the monetary policy for the eurozone.

A clause inserted into the text creating the single banking supervisor allowed the ECB to take over supervision of a lender at the request of the ESM, the eurozone bailout fund. This paved the way for an emergency injection of capital, but it would require unanimous approval.

Eurozone countries eventually dropped objections to George Osborne's (and thus the United Kingdom's) demands for a "double majority" principle at the European Banking Authority, the EU agency responsible for coordinating the work of national supervisors. Osborne's views were supported in various Ecofins by Maria Fekter, the Austrian minister, and Luc Frieden, the Luxembourg minister. I also chimed in on this issue. This principle ensured that any European Banking Authority decisions were at least approved by a plurality of EU countries outside the banking union—that is, noneurozone countries.

A showdown between big and small countries over the voting arrangements for setting regulations within the banking union emerged as the final outstanding issue. Luxembourg and Austria led objections to scrapping the ECB's one-country, one-vote principle in favor of weighted votes that gave France and Germany greater clout. I was also very active in the discussions, supporting the written views of the Bulgarian National Bank. The final compromise involved combining both voting procedures so that a simple majority and a weighted majority would be required for any decision.

In the negotiations for establishing the single banking supervisor, the ECB insisted that it begin operations by reviewing the participating banks' balance sheets. The objective of this review was to identify past problems and start with a system that avoided reputational risks for the single banking supervisor in the future. Germany supported this proposal, and it was accepted over the objections of several eurozone members such as France and Spain. These countries feared that the review might result in fiscal obligations if impaired assets had to be written down.

The single banking supervisor was open to the participation of all EU countries, including those that had not adopted the euro. At the December 2012 Ecofin, I recounted why a noneurozone country like Bulgaria was interested in participation. The single banking supervisor, and the accompanying single rulebook, would unify supervisory and regulatory practices across Europe, and participation of Bulgarian banks in the system would boost confidence in them as well. Here my views differed from those of the governor of the Bulgarian National Bank. He argued that countries like Bulgaria that had undergone banking crises (for Bulgaria, in 1997–98) had gained significant supervisory expertise and were better off supervising themselves. That point was also made forcefully by former Polish finance minister and central bank governor Leszek Balcerowicz. But what I feared was an imbalance between Bulgarian-owned banks and banks owned by eurozone financial institutions. If Bulgaria opted out of the single banking supervisor, would Bulgarian-owned banks be stigmatized?

Based on my experience with the European semester and analysts in Brussels, I knew Frankfurt-based single banking supervision would take a long time to develop. So it was a reasonable position that for a decade or so national authorities would be in a better position to supervise their own banks. Cooperation would be ongoing between Frankfurt and Sofia, but supervision would be stricter, not more lax, if carried out by Bulgarian experts. By January 2013, I was defending this position.

Putting the Final Touches on the Single Banking Supervisor

In March 2013, the European Parliament approved the European Council's texts on the single banking supervisor with some hotly disputed changes. Most arguments were over the appointment of top officials at the new single supervisor. For example, how would the European Parliament ensure that women were given a fair chance to be board members? The ECB had a dismal record in that area. Martin Schulz, the president of the European Parliament, insisted on having a say in appointments. Draghi was at first incredulous and then indignant. At some point, a humorous counterproposal even emerged: "You appoint our governors, and we would have a say in appointing the leadership of the European Parliament." In the end, a compromise was reached: The European Parliament would have the right to approve the ECB's candidates for chairman and deputy chairman of the supervisory board.

With these final decisions, the single banking supervisor finally took shape. In my view, progress on the details was so brisk because the ECB had won the day in 2012 and now enjoyed a reputation among politicians as the most trusted institution in Europe. Draghi and Asmussen were enjoying their high credibility standings as well. The ECB could handle building a single banking supervision capacity, whereas the European Commission was not viewed so kindly—the majority of Ecofin ministers had misgivings about the capacity of Commission staff to handle a fiscal union.

But just when the preliminary work on the single banking supervisor seemed to be finally done, there was a surprise—this time from Washington. In April 2013, during the World Bank/IMF spring meetings, German finance minister Wolfgang Schäuble and the head of the Bundesbank, Jens Weidmann, caught people off-guard by saying that the European Union should move ahead with the treaty changes they believed were needed to create a banking union for the eurozone. Schäuble argued that although current EU law would allow the ECB to act as a single banking supervisor, setting up a new single resolution authority to restructure or wind up failed banks would require changes to the EU treaties. That process would take years because the revised treaties would have to be ratified by 28 member state parliaments.[14]

I was in Washington at the time and listened to Schäuble's arguments. He had made this point in Ecofin meetings, and he was also among the ministers most actively pursuing an agreement on the single banking supervisor. I thought that, in the end, he had accepted the agreement with its limits on which banks the new authority could supervise. The day of the Schäuble-Weidmann press conference I met Jörg Asmussen in the street and asked whether he was surprised. No, he said. He had worked with both of them and knew their views. Perhaps they were simply being cautious to ensure that unreasonable expectations were not tied to the role of the single banking supervisor.

Asmussen's view was consistent with Schäuble's later explanation. "The German government is willing to change the treaties: the sooner, the better," he pointed out. "Banking union only makes sense . . . if we also have rules for restructuring and resolving banks. But if we want European institutions for that, we will need a treaty change."[15]

To allay Germany's concerns, the ECB offered a gradual plan within days. Asmussen, who was a member of the ECB Executive Board, commented: "In our view this should be dealt with swiftly, since we want to have the bail-in instruments available in 2015, not in 2018."[16]

---

14. For a view of the transitional path toward a full banking union, see Nicolas Véron, "Europe's Banking Union: Possible Next Steps on a Bumpy Path," VoxEU.org, July 12, 2012.

15. Peter Spiegel, "Schäuble Warns EU Bank Rescue Agency Needs Treaty Changes," *Financial Times*, May 12, 2013.

16. Annika Breidthardt, "ECB's Asmussen Wants Single Bank Supervision, Resolution Next Year," Reuters, May 14, 2013.

Treaty changes for a single resolution authority could come later. The policy experts agreed (Véron 2013); the limitations of the treaties did not prevent the establishment of the Single Supervisory Mechanism. Until the treaties could be revised, the ECB would review the banks to come under its supervision and analyze their condition before taking charge of them.

The leaders of southern rim countries argued against such a gradual approach. On May 13, 2013, for example, the prime ministers of Spain and Portugal demanded that the eurozone speed up efforts to create a banking union and complained that credit was frozen in their countries, preventing economic growth and crucial job creation. Many banks were lending at high rates because they were worried about the weak economy. "The money from the banking system isn't getting to the businesses or into the economy," argued Portugal's prime minister, Pedro Passos Coelho.[17]

The German response was swift. "We should not make promises we cannot keep," Schäuble told the *Financial Times* the next day, proposing that Europe first rely on cooperation between national agencies.[18] "Current treaties don't give enough foundation for a European restructuring authority," Schäuble argued. "You can do the same thing very well with a network of national authorities."

Banking Union: A Work in Progress but How Long?

The truth is that no one was prepared for the banking union. Realistically, establishing it would take a decade. For one thing, the ECB does not have enough qualified people; it would have to go on a hiring binge. But because such capacity exists primarily in the national banking authorities, that would mean hiring people away from central banks. For another, just as in a fiscal union, it is not at all obvious that central supervision is superior to national supervision. Bulgaria, for example, has had a strong banking supervisor since the 1997 banking crisis and the creation of the currency board. What guarantees are there that the supervisors in Frankfurt would be as good? And then there is the fact that some countries such as Bulgaria and Poland have fully paid-in guarantee funds in case of bank distress. Other countries have no such funds. Establishing a common fund would mean pooling the assets of existing funds with the nonexistent assets of other countries. Understandably, that would not work.

The first steps toward a banking union will be taken after November 2014, the new date at which the ECB will assume its role as the Single Supervisory Mechanism after examining the balance sheets of the 130 largest eurozone banks. ECB analysis suggests that a period of restructuring in the European banking sector will follow, especially by means of mergers and acquisitions.

---

17. Associated Press, "Spain, Portugal Demand Quick Action on Bank Union," May 13, 2013.

18. Quentin Peel, "Schäuble Calls for Closer EU Integration," *Financial Times*, May 17, 2013.

Such restructuring would make European banks more competitive vis-à-vis their US and Asian competitors.

In the meantime, the discussion about a centralized banking supervisor versus a network of national supervisors continues. In November 2013, ECB president Mario Draghi sent a letter to the heads of EU institutions arguing that "a single mechanism is better placed to guarantee optimal resolution action than a network of national resolution authorities. Co-ordination between national resolution systems has not proved sufficient to achieve the most timely and cost-effective resolution decisions, particularly in a cross-border context."[19] Draghi's letter also suggested there was no need for treaty changes to create a strong, centralized authority.

My view of the actions of the ECB changed over time. In 2009 and 2010, I questioned the refusal of ECB president Jean-Claude Trichet to assist the Baltic banking systems, as well as the Hungarian and Romanian banks, in the same way that the ECB had poured money into southern rim countries. Had Trichet been more decisive, the crisis in these countries would have been less severe. In 2011, when Trichet began to emulate the actions of Federal Reserve chairman Ben Bernanke in the United States, it seemed too late. And it stood in the way of undertaking genuine structural reforms in countries such as Greece and Italy. The chronic hesitation of European politicians to undertake reforms just made the crisis worse and closed many policy options that would have been useful if implemented at the onset of the crisis. Had the ECB not intervened as strongly as it did in late 2011 and then in 2012, the eurozone would have lost some of its members. And so in the end the ECB did the right thing. But it took Mario Draghi and Asmussen to do it. The United States had the right decision makers all along: Ben Bernanke and Obama administration economic advisor Lawrence Summers.

19. Peter Spiegel, "ECB on Collision Course with Germany on Banking Union," *Financial Times*, November 8, 2013.