TOWARDS THE EUROPEAN BANKING UNION:

IMPLICATIONS FOR THE GREEK BANKING SYSTEM

GEORGE S. ZAVVOS

Legal Adviser, Legal Service - European Commission
Former Member of the European Parliament, and
EC Ambassador

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1. I would like to thank the Levy Institute for the invitation to participate in the Conference where some of the most crucial issues of European integration are debated. I would like to particularly thank its insightful President, Dimitri Papadimitriou, who with a crucial mass of dedicated colleagues have spread Minsky's thinking even during the years of economic orthodoxy's dominance.

2. Through a strange coincidence of history these very days we celebrate two important events that shaped Europe's destiny and whose shadow still ponders upon us today: the fall of the Berlin Wall (9 November 1989) and the ratification of the Maastricht Treaty (1 November 1993). These are two landmark geopolitical references which stirred ideological upheavals of vital importance for Europe. With the fall of the Berlin Wall, some rushed to celebrate the final victory of Western-style democracy, the exemplary model of a market economy and the monopoly of US world dominance. With the adoption of Maastricht some thought, and still think, that the EU could advance based on a single currency zone not supported by a political authority. Both have misread history and its lessons.

3. Sometimes overtaken by the force of a devastating crisis, Europe seems to be departing on a bipolar expedition; centrifugal powers between the centre and the periphery (between "creditors" and "debtors") seriously test EU's solidarity which is one of the cornerstones of its unity. Europe, 24 years after the fall of the Berlin Wall, cannot afford a new geopolitical schism that would relegate it to the laggards of the international system and would shatter any prospects of political unity.

I. RATIONALE AND FOUNDATIONS OF THE EUROPEAN BANKING UNION

4. The ongoing crisis is rapidly transforming the European Union. It has tested its financial theories, structures and policies and has found them severely failing. The fragmentation of the EU financial market proved a lethal threat to the premises of the EU but also to the economy of periphery countries, like Greece, who bear a disproportional cost of funding their needs.

5. The crisis revealed that the Treaty of Maastricht was founded on a dangerously asymmetric institutional design: one currency zone coexisting with numerous national banking supervisory authorities and nationals budgets. It desperately failed to reflect Minsky's financial instability hypothesis. To the contrary, its working hypothesis was that only the over-indebtedness of the public sector could be a source of instability. However, the Euro area crisis was fundamentally due to the over-indebtedness of the private sector which was financed by the banking system (e.g. in Ireland and Spain).

6. The real lesson of the Great Recession is that the shocks that hit the Euro area were not due to the normal business cycles but to the boom and bust cycles caused by the over-indebtedness of the private sector which put at risk the entire financial system. Financial shocks are not as frequent as business cycles shocks but when they occur they have a devastating effect. Normal business

cycles in the pre-2007-2008 period led to 1-2% fluctuations of the GDP. However in the aftermath of the 2008 crisis some Member States have experienced a double-digit fall in their DGP – in the case of Greece over 25% – and the collapse of their banking system.

7. Due to the permanent and devastating nature of financial shocks, it is apparent that the Euro area needs a powerful Banking Union as the vital financial shock absorber. This could diminish the impact of crises not only on the banking sector but also, indirectly, on Member States' public finances. Even if a Fiscal Union were in place with unemployment schemes, still, based on the US experience, this would have only repaired the GDP by 1% -5%. Thus, the establishment of the Banking Union can serve as a partial substitute of a Fiscal Union.

8. The Euro area was built on the optimal currency zone theory which professes that its functioning can be improved through two means: labor mobility and fiscal integration, i.e. an important part of Federal spending that could help regions or States to cope with asymmetric shocks. However, none of these were in place when constructing the Euro. At that time, the primary concern was coping with exogenous shocks and not with the endogenous ones caused by the banking system, as Minsky had insightfully advanced. If the Nobel laureate Professor Mundell had to revise his theory of optimal currency zone with the hindsight of the Euro area crisis he would most probably propose as a *conditio sine qua non* the establishment of a banking union rather than a flexible labor market.

9. A comparison between the US and the EU market structure and supervisory systems is revealing. As the ECB's recent study shows in the Euro area domestic banking sector assets are close to 270% of the GDP on average (though this can vary from 4% for Estonia to 400% for Cyprus). The corresponding figure for the US is 72%. This shows the significance of the EU banking sector and its implications for the sector's concentration ("too big to fail"), supervision and resolution. In the US, the supervision, restructuring and recapitalization of banks takes place at federal level. The Federal Deposit Insurance Corporation (FDIC) has the power to restructure and recapitalize one State's ailing banks with the burden being shared amongst all States. In addition, recourse to the US Treasury for financing and guarantees is provided through its Troubled Assets Relief Program (TARF). In fact, around 490 non-viable US banks have been resolved since 2008. Around 450 of them have been involved in what is called "Purchase and Assumption", i.e. selling components of banks established mostly in other States. All this is treated as business as usual and not as a destabilizing factor spreading contagion.

10. In July 2012 the EU hastily proposed the establishment of the European Banking Union (EBU) to break the vicious circle between sovereigns and their banks. The EBU comprises: a) the Single Supervisory Mechanism (SSM), with the European Central Bank (ECB) acting as the EU's chief banking supervisor, b) the Single Resolution Mechanism (SRM), consisting of the Single Resolution Authority (SRA) and the Single Resolution Fund (SRF);

and c) the European Deposit Guarantee System. All these exist in the US since 1933. Europe is just starting.

11. In my view the EBU is the most important political undertaking since the adoption of the Maastricht Treaty in 1991. It aims at breaking the doom loop between sovereigns and their banks and saving the Euro; it will enhance the monetary transmission mechanism as well as contribute to financial efficiency and economic growth. Along with the Monetary Union, the Fiscal Union and the Economic Union it is an indispensable step towards the Political Union and a Federal Europe.

12. Since the Maastricht Treaty did not provide for supranational supervision and crisis management structures for banks one of the biggest hurdles has been the establishment of the EBU within the current institutional framework. A further complication is that not all Member States are ready or willing to join the EBU right now. Thus, it has to advance with the Community method and through differentiated integration.

II. EUROPEAN BANKING SUPERVISION

13. After a 20-year complacent period the EU adopted, in just 13 months – a record time, the Single Supervisory Mechanism (SSM) which should be in force by this time next year.

14. The SSM sets up a two-tier supervision system including the ECB and the national authorities. The ECB will become the direct supervisor of 130 systemically important banks coming from at least the 18 Euro area Member States; their assets represent 85% of the Euro area assets. The SSM will have its own decision-making mechanism and will dispose important micro- and macro-prudential supervision powers. Since the ECB has already effectively played the lender of last resort of the Euro area banking system, supervision of banks cannot be left to the national authorities; it should be assumed at the European supranational level. One crucial accomplishment is that the SSM brings within a credible European institution the three fundamental functions of any central bank, i.e. the monetary function, the supervisory function and payment systems.

15. The SSM will operate as a unitary structure ("functional federalism"), even though it comprises the ECB and the national supervisory authorities. Thus, the ECB will:
    - directly supervise all systemically important banks
    - be able to bring under its supervision any bank not directly supervised if it is perceived as raising systemic threats
    - issue guidelines, regulations and manuals that will have to be observed by all the participants to the system
    - receive all supervisory data
    - supervise and monitor overall supervisory quality.

16. According to the Treaty, the ECB should be fully independent when conducting its monetary policy. The SSM Regulation provides the necessary

guarantees to ensure that the ECB's monetary independence will not be affected by decisions on supervision taken by the Governing Council of the ECB. In my view, the new supervisory structure will create important functional synergies between monetary policy and macro-prudential supervision which is of essence for the enhancement of financial stability.

III. RESOLUTION OF BANKS IN THE EU

-*The Bank Recovery and Resolution Directive*

17. The Euro area crisis has shown that a sound legal framework is needed to avoid having recourse to taxpayers' money to save the banks. This would also dispel the misleading perception which the Cyprus banking crisis may have created that the choice of bank restructuring and resolution depends on the solvency of the sovereign. In other terms, if the sovereign is financially weak then it would bail-in investors and bondholders whereas, if the sovereign is fiscally strong then it could opt for a bail-out.

18. In order to ensure a harmonized framework for the recovery and resolution of banks throughout all 28 EU Member States, the Commission has proposed a Banking Recovery and Resolution Directive (BRRD); amongst others, it comprises three important and interrelated mechanisms: a) the bail-in tool (i.e. the order through which shareholders and creditors will have to undergo the bail-in process); b) minimum requirements for own funds and eligible liabilities (MREL); and c) financing (through national resolution funds).

19. The bail-in clause sets out an order of priority of claims, i.e. first shareholders, then junior bondholders and, at the end, non-covered depositors. Even though not initially included in the Commission proposal, the principle of "depositors' preference" was introduced during the negotiations. Accordingly, non-covered depositors' claims will be bailed-in only after junior bondholders have been called in.

20. The BRRD tries to strike a balance between, on the one hand, the need to set clear harmonized bail-in rules and, on the other hand, to provide Member States with some discretion to adjust the mechanism to their needs. This has proven to be a rather tortuous task. While a set of harmonized rules enhances legal certainty and the confidence of investors, some argue that the national discretions could create an uneven playing field among the 28 Member States allowing solvent States to bail-out their systemically important banks but forcing fiscally weak states to bail-in their shareholders and creditors.

21. The BRRD also provides that every Member State should set up a National Resolution Authorities and Resolution Funds which would be funded ex ante by the banks. The financing should amount within 10 years to 0.8% of covered deposits.

22. The European Council on 24 October 2013 undertook the political commitment that the BRRD and the revised Deposit Guarantee Systems Directive would be adopted by the end of the year. In addition, it stipulated

that there should be a political compromise regarding the SRM before the end of the current legislative period (May 2014); in other terms, this important political compromise should hopefully be attained under the auspices of the forthcoming Greek Presidency.

-***The Single Resolution Mechanism***

23. The introduction of the SSM renders indispensable the establishment of a parallel mechanism for the recovery and resolution of banks at the EU level. Despite the progress achieved by the BRRD, it is feared that the cooperation of national resolution authorities cannot avoid delays, increased costs and market fragmentation. According to the Commission proposal the SRM comprises: a) the Single Resolution Authority (SRA) and b) the Single Resolution Fund (SRF). The basic principles for the resolution of banks as enshrined in the BRRD are also reflected in the SRM Regulation.

24. While 130 systemically important banks will be directly supervised by the ECB, it is proposed that all EU banks come under the SRM. However, several Member States argue that the scope of the SRM should be the same as the one of the SSM (i.e. including only the 130 Euro area systemically important banks), with the remaining banks left to the national resolution authorities and the national resolution funds.

25. The new SRM proposal is a fertile ground for legal and institutional debates on the legal basis and the competences of the various actors, as I have already discussed extensively in my paper for the 22nd Annual Hyman P. Minsky Conference “Building a Financial Structure for a More Stable and Equitable Economy”.

26. The SRA will have centralized powers and will enforce rules in a uniform manner. The proposal envisages that a European Board – composed of representatives of the Commission, the ECB and the relevant national authorities – will prepare and adopt recovery and resolution plans whereas the European Commission, a European institution that can take decisions involving a large margin of discretion, will adopt the resolution decisions. Another reason that militated in favor of the Commission assuming this role is the experience it has acquired in implementing the State aid rules in the banking sector and the sector’s restructuring. Thus, while national authorities and the ECB may propose the resolution of a bank, only the Commission will be able to take the final resolution decision. The decisions of the Commission and the Board will then be implemented by the competent national authorities.

27. It is still not entirely clear which would be the precise relationship/articulation between the bail-in mechanism, the national resolution funds, EU State aid rules, the European Stability Mechanism (ESM) and the SRF. The BRRD requires all Member States to built-up national resolution funds. Similarly, the SRM Regulation also provides for the establishment of a Single Resolution Fund; however, until its creation there should be an EU public backstop, i.e. an entity that would provide financing as a means of last resort for banks’ direct capitalization when national funds do not suffice.

28. Based on the decisions of the European Council, it can be assumed that the ESM could play this role provided that its rules were amended so that it is afforded with: a) sufficient financial capacity; currently only EUR 50 million have been earmarked for banks; b) a speedier and more flexible decision-making process, i.e. decisions should not be taken on a unanimity basis and should not be subject to the approval of individual national parliaments; c) permission to directly capitalize banks and not through lending money to the Member States. Ideally, the ESM should, in the mid-term, operate as a fully-fledged European institution. Another practical question is whether in the future non-Euro area Member States which participate in the SSM and the SRM will be able, in case of need, to access ESM financing.

IV. RESTRUCTURING AND RECAPITALISATION OF BANKS

29. An important restructuring of the banking sector has already taken place. It is estimated that Euro area banks have raised EUR 225 billion of new capital since the beginning of the crisis and that EUR 275 billion have been injected by the governments, an amount equivalent to 5% of the Euro area GDP. A few days ago, the ECB launched a comprehensive assessment of the credit institutions participating in the SSM. This will be followed by stress tests which the ECB will conduct with the EBA. This exercise is crucial to: enhance transparency; repair the damages; reinforce the confidence of investors in the banking system; and restore normal conditions.

30. During the transition period until the ECB assumes its supervisory powers, the comprehensive assessment exercise may reveal that a number of banks lack the required capital. This calls for arrangements which will facilitate the recapitalization without causing any systemic problems to the EU banking system. It could be expected that ailing banks that cannot raise the necessary capital from the markets would be bailed out by their Member State’s public backstop. Only in case this is not sufficient could they have recourse to the ESM. With this neuralgic operation the Euro area will identify banks’ capital inadequacies and ensure that sufficient financial firepower is in place at national and EU level.

31. One of the open issues of this exercise is the treatment of **banks’ “legacy loans”**. On this there are two rather diverging positions: on the one hand, some Member States argue in favor of the principle of “control-liability”, i.e. that Member States “at fault” and not the ESM should bear the cost of restructuring the legacy loans of their banks. On the other hand, other Member States advance that the ESM should be directly financing banks’ legacy loans as there is a “shared responsibility and liability” amongst Euro area Member States. In fact “creditor” states' banks and their supervisors are responsible and liable for authorizing the profligate over-lending to “debtor States” and to their banks. Furthermore, if debtor States’ budgets were called to bear alone the disproportionate burden to support their ailing banks, their debt would be increased and the vicious circle between banks and sovereigns would be perpetrated.

32. Last August the Commission adopted special State aid rules regarding distressed banks. Accordingly, a bank can be bailed-out only after: a) the burden is first borne by the banks (bail-in); b) the Commission has approved the restructuring plan involving any recapitalization or impaired assets relief; c) the State aids rules apply to the executive remuneration. Up to the full operation of a Single Resolution Mechanism the implementation of EU's State aid rules will have a major role in the restructuring of ailing European banks.

V. IMPLICATIONS FOR THE GREEK BANKING SYSTEM

33. Greece is currently going through a painful period mainly due to the failings of a profligate State which drew down with it the banking sector. Contrary to the case of Ireland and Spain, Greek banks were not the main cause of the crisis in the country. Up to 2007-2008 they were thriving and had turned South-Eastern Europe into the genuine hinterland of the Greek economy. Greece besides its own failings paid dearly the lack of sound and resilient EU supranational institutions for supervision and crisis management which could have contained the crisis at an early stage. Had the EBU been in place at that time the fragmentation of the EU market, the massive exodus of depositors and the liquidity crunch would have been considerably averted and the impact of the crisis would have been mitigated.

34. The EBU as the key response to the Euro area crisis will have far-reaching implications on the Greek banking system and the Greek economy. It will affect the institutional and legislative framework, the model of bank financing and it will be crucial for Greece's potential to recover and exit the crisis. These short- and mid-term developments are bound to transform the banking and financial system as it is known over the last twenty years.

35. At this juncture, the Greek and the EU authorities rightly focus on the recapitalization of banks and the stabilization of the Greek banking system. However I believe that it is now the time to think and design the reform of the post-crisis Greek financial system. We should not wait for the recession to end because a sound banking system is of strategic importance to exit the crisis and support a new model of growth and employment.

36. The fundamental question is what kind of banking system we want. The banking system does not function in an economic and political vacuum. It is a vital component of the economy and society. The reform of the banking sector will navigate uncharted regulatory waters; it thus requires an in-depth understanding of and experience with the European and national regulations. The EBU provides room to develop a financial system based on new sound principles adjusted to the domestic and regional needs which vary considerably throughout Europe. In Europe there is no "one-size fits all" economic and banking model; on the contrary, the new framework will allow a diversity of financial models and will enable every Member State to identify its needs as well as develop and maintain its comparative advantages. Within this new, more stable and more resilient framework Greece should develop its own specificities corresponding to the needs of the Greek economy and society.

37. While not all EU measures and policies which will affect the reform of the Greek banking sector have been adopted or implemented yet, the following issues should be highlighted.

A. Restructuring and Recapitalization of the Greek Banking Sector

38. For the next 12 months, the ECB will undertake, in close cooperation with the Greek Central Bank, the comprehensive assessment of the Greek banking sector. This assessment is of utmost importance to regain the confidence of investors and depositors so that Greek banks play their intermediation role as lenders of cheap financing. The ECB's exercise comprises three elements: a supervisory risk assessment, a balance sheet assessment and a stress test. All these should be concluded before the ECB assumes its supervisory responsibilities at the end of 2014. Four Greek banks are amongst the 130 Euro area banks which have to go through this rigorous auditing exercise in order to identify and repair any capital loopholes. In general, this restructuring means that non-viable financial institutions will need to close down while the viable ones which lack capital will need to be recapitalized and strengthened. In this regard the ECB has underlined the importance of having available a national public backstop.

39. During the comprehensive assessment it is of importance to comply with the capital threshold required by the ECB. It is said that today the median Core Tier I capital ratio of the biggest Euro area banks is close to 12%. As of 1.1.2014 the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD) will introduce a new regime for capital adequacy. While 75% of the capital adequacy rules will be directly applicable to Greek banks and will be supervised by the ECB (as they are adopted through a Regulation), the remaining 25% of the rules should be implemented by the Greek Central Bank. One of the important innovations is that the ECB and the Greek Central Bank will be able to impose macro-prudential capital adequacy rules, e.g. to avert a real estate bubble.

B. Reinforcing the Institutional and Supervisory Infrastructure of the Greek Banking System

40. The implementation of the SSM creates a new dynamic symbiosis between the ECB in its new supervisory role and the Greek Central Bank. This will have an important impact on the redesigning and function of the Greek supervision system. The Greek Central Bank will become a functional component of the federal supervisory mechanism (SSM) and will have to adjust several of its structures and activities. As of this time next year the four biggest Greek banks will come under the direct supervision of the ECB which, in cooperation with the Greek Central Bank, will exercise its new supervisory role. The SSM signals an important change from national to joint / EU supervision which requires mutual trust and genuine cooperation between national and EU authorities. The new EU system should be rather described as a unitary system since there will be an allocation of tasks between the ECB and the national authorities. More specifically, national supervisory

authorities' contribution is important as they have thorough knowledge of the national situation, can obtain the necessary information from banks and possess the required skills. A key operational element will be the Joint Supervisory Teams which will be composed of ECB and national experts overseeing the systemically significant banks.

41. I do believe that this is a significant game changer with considerable benefits. Supervision by the ECB will enhance the financial stability and credibility of the Greek banking system; it will warrant increased impartiality and independence as there will be no suspicion of political influence or national bias. Indeed, the proclaimed objective of the EBU is to free banking supervision from national politics, improve the governance of banks and challenge the vested interests in public policy and the corporate sector.

C. Establishing A New Bank Recovery and Resolution Regime for Greek banks

42. The forthcoming adoption of the BRRD and the SRM will provide a sound safety net for the Greek banking system triggering a broad legal, institutional and structural reform. More precisely:

    a. A new Greek law will have to transpose the BRRD into the Greek legal order. This Directive will come into force most probably by 1.1.2015. The new recovery and resolution framework is a legal *terra incognita* combining novel supervisory and insolvency law principles and techniques. It will enshrine into the Greek legal order the new harmonized "bail-in" rules which, however, will provide Member States with some flexibility to adapt them to the national needs. Transposition of the BRRD will entail a systemic reform of fields such as insolvency law, supervision, company law, tax law, competition law, labor law etc.

    b. The establishment of a New Greek Recovery and Resolution Authority is provided by the BRRD; this authority should be fully equipped to trigger and decide the recovery and resolution of nationally supervised banks. Greece should decide where to set up this authority and how it will relate and cooperate with the national backstop and the deposit guarantee system. It will also cooperate with other Member States' recovery and resolution authorities and will be part of the system set up by the SRM.

    c. The establishment of a National Resolution Fund which should be adequately funded ex ante through the contributions of the Greek banks; thus, if a bank lacks capital and is not be able to finance itself through private sources (shareholders/bondholders), the fund would act as a public backstop. Greece will need to decide whether it will merge its national resolution fund with the deposit guarantee system or will keep them as separate entities.

    d. Following the ECB's comprehensive assessment of the Greek banks, it is understood that a national public backstop should be available to support the recapitalization of banks. This is indispensable, especially during the assessment period that some Member States may need to reinforce the capital of their banks.

e. EU authorities envisage the adoption of a revised Deposit Guarantee Directive before the end of the year; this would render necessary the institutional reinforcement of the existing Deposit Guarantee Fund with simplified protection of depositors, speedier payout procedures and improved financing capacity.

f. A broader reform of the Greek financial system has to include parallel reforms in EU securities and capital markets (EMIR, Solvency II) aiming at the creation of a deep and liquid capital market.

D. Innovative Financing for the Greek Economy

43. While the above reforms are urgent and they have beneficial mid-term effects, the improvement of banks' lending environment at this juncture is of existential importance. Financing in Greece comes across the following obstacles:
    - an equity funding gap and a structural debt funding gap of the order of Euro 5-10 billion
    - an insufficient supply of project finance, working capital and import/export financing
    - lack of specialized financial institutions (e.g. mortgage banks, savings banks, etc.)
    - need for specialized financing institutions for growth.

44. Greece in the after crisis years will need significant investments to rebuild its physical and human capital because this will be the drive of the recovery. SMEs are the backbone of the Greek economy and it is no secret that banks should play a major role in their financing. I understand that consistent efforts are currently taking place to support this. In the coming days the Commission will announce an array of measures specifically adjusted to meet the needs of SMEs which would be of benefit to the Greek economy. Besides the stabilization of the commercial banking sector, the reform of the Greek banking system should be inspired by the positive experiences of other Member States that have thriving savings and cooperative banks sectors, as well as specialized institutions that have supported SMEs since 2008.

45. The reform of the Greek banking and capital markets sectors along with a consistent, export-driven economy will give a positive signal to the markets and will therefore strengthen the investment climate.

E. The Regional Dimension

46. The Greek economy is inextricably linked to South-Eastern Europe. Thus, Greek banks should not only be able to meet the domestic needs but, in the mid-term, should also be able to maintain their presence in this region as this would support Greek investments and exports.

47. To the extent that Greece's neighboring countries will also participate in the EBU (e.g. Bulgaria, Romania) and benefit from the European supervision and its financial backstops, the financial stability of the broader South-Eastern European economy will be reinforced.

F. Rebalancing Europe's Asymmetric Finance

48. The EBU will reduce the fragmentation of the financial market which deprives liquidity even in banks with cross-border presence. At the same time the EBU will accrue important advantages for the Greek banks as, given the increased confidence in the system, they will have to pay lower interest rates in order to attract deposits, the very basis of their funding. Furthermore, in the mid-term the EBU will contribute to the rebalancing of the situation whereby huge deposit surpluses are concentrated in some Member States which currently enjoy a safe haven status, while other peripheral ones are starving for cheap finance. By the end of the day, the litmus test of the EBU will be rebalancing the asymmetric access to finance between Northern and Southern Member States, i.e. its capacity to reduce the exorbitant divergence between banks' funding costs and lending rates depending on the country of establishment. In this way Greek enterprises would be encouraged to access a single pool of savings to finance their needs.

49. Greece as a periphery member of a non-optimal currency zone has been suffering from the asymmetric shocks that have hit periodically the Euro area. I hope that the EBU, when completed, will enhance the financial stability and the efficiency of the Greek banking system. The EBU will provide an important shock absorber mechanism which will render the Greek banking system more resilient. The Federal Supervision and Federal Crisis Management mechanisms (SSM and SRM) will ensure enhanced stability for supervising banks but also adequate burden-sharing mechanisms for all participating Member States. Within the fully-fledged EBU, depositors of Greek banks will enjoy the same level of security for their deposits as in any other EU bank. Hence, the phenomenon of frightened Greek depositors hastily seeking safe havens abroad (depriving the Greek banks and the Greek economy of its liquidity) will be significantly reduced.

VI. FROM THE EUROPEAN BANKING UNION TO THE EUROPEAN FEDERATION

50. As already mentioned, the EBU is intrinsically linked to the Monetary Union and the Fiscal Union while being a step towards the European Political Union. The Commission's Blueprint for a deep and genuine Economic and Monetary Union of 28 November 2011 and the four Presidents' Report set a fertile ground for the most needed public debate on the future of European integration.

51. The crisis confirmed the nexus between the Monetary Union and the Banking Union by revealing that a single currency cannot exist without Federal banking supervision. That is the US lesson of the last 80 years. The ECB's

money supply is only a part of the broader money circulation that is created by the banks' loans. Thus, a fragmented banking system obstructs money circulation, paralyses the monetary transmission mechanism and prevents the economy from enjoying the full benefits of low interest rates.

52. There is also a vital link between the Banking and the Fiscal Union. Dealing only with the ailing banking sector is not sufficient to break the vicious circle between banks and sovereigns; it is also essential to address sovereigns' public finance problems which are also hit by asymmetric shocks. Since sovereigns run the risk of being cut out of access to capital markets, as was the case in Greece, it is essential to advance to a form of limited Fiscal Union with fiscal capacity to support public finance. Furthermore, it would be important to establish a European Debt Agency which would be able to issue limited type of bonds (e.g. redemption fund) to finance States in need. Eurobonds should not only be perceived as support to Member States' public finance but also as a crucial component of a liquid European capital market, able to provide competitive financing to European enterprises and to counterbalance the failings of the banking system. As the EU backstops (e.g. the ESM) will be using public money for risk sharing in support of Member States and/or the banking sector, such decisions must be made by genuine EU Federal institutions.

- The European Political Union

53. Up until now Europe oscillates between the invisible hand of markets and the hesitant hand of States. The incremental actions adopted so far have proven insufficient. The quintessence of European Union's ongoing banking reforms is rebalancing the disturbed relation between markets and politics, i.e. framing capitalism with rules of political authority and advancing democracy at the supranational level.

54. European national political elites, while recognizing the urgency of establishing supranational structures, are often reluctant to confer sovereignty to supranational institutions. However, a forceful response to the democratic deficit would be the building of strong and accountable supranational institutions capable of delivering "public goods", including financial stability. These institutions should be embedded within a European Federation guaranteeing the rule of law, dispersal of powers and active citizen participation. While there is a strong European *demos* asking for urgent reforms, there is not yet a European *kratos*, a European polity to sufficiently deliver the public goods. Europe is currently undergoing a unique transformation of sovereignty. Power has emancipated itself from the national governments which become accountable principally to global financial markets. To regain their lost political authority we need to build strong European Federal institutions.

55. In the forthcoming European Elections political leaderships are undergoing the acid test of political legitimacy; they have to show if they can put aside the relics of the Westphalian era that keep Europe hostage from turning into a dynamic global player. They will be tested whether they can reverse the

introvert, xenophobic and populist moves which thrive during the crisis. In the 2014 European Parliament Elections the European political parties should, amongst others, directly elect the President of the European Commission. It is also important that a possible European Convention as of 2015 deals with the fundamental issues of the European Federation.

56. The current global economic crisis revealed the fundamental failings of the market economy which lacks institutional limits, gradually reversing the geo-economic hierarchies and shifting the geo-economic focus from the US to China. The evolving international institutions increasingly reflect this change through the enhanced presence of the new emerging powers. Contrary to their economic orthodoxy, the bastions of Anglo-Saxon capitalism have essentially nationalized their largest banks and financial institutions. Today, strangely enough, the best students of Adam Smith are in Beijing and New Delhi. Western societies, in an elusive search of growth, are now looking to the new forces of the capitalist archipelago of East Asia. While in the Western post-Enlightenment thought "rule of law" and economic growth go hand-in-hand, communist China's accomplishments question the validity of the claim that parliamentary democracy is the necessary and essential condition for sustainable economic growth.

57. Europe in the era of globalization, startled by the upheavals in the geopolitical chessboard and the monumental crisis, is likely to be in the slow lane of the global race unless it drastically reverses its priorities and moves towards a Political Union. Despite its accomplishments Europe faces an existential dilemma: political integration or marginalization. This forces us to make geopolitical choices: Europe as a zone of economic prosperity, performing tasks delegated by others, or Europe as a credible geopolitical partner who co-shapes the new system of global governance and sets the template of open society.

58. In this time of geopolitical transformations small States' survival is dependent on more than their economic performance. The gradual preponderance of politics over markets urges small (peripheral) Member States (like Greece) – as well as the ones perceiving themselves as large ones – to be safely embedded within a solid Political Union and federal European structures. Small States are the first victims of the lack of strong European Institutions and of the intergovernmental approach, where the strong commands the shots and the others follow. This is why a steady march to Political Union is a guarantee of democratic governance where any concentration of power will be dispersed and where every Member State will be free to develop its culture and identity.

59. That is why the advent of the EBU is a fundamental game changer; because it reverses the dominant political assumptions on sovereignty and subsidiarity that allocated banking supervision powers to national authorities. For this reason the EBU signals the most important political initiative since the adoption of the Maastricht Treaty. It is the indispensable component of the Monetary Union but also the requisite companion of the Fiscal Union. It is the stepping stone leading to the European Federation.

60. Whenever in difficult times we lack the courage to continue towards a Federal Europe we should reflect on the words of the great European visionary and Central Banker, the late Tommaso Padoa Schioppa:

"*The process of European Unification is the most valuable legacy left by the 20th century in the field of politics. (...) It has been a revolution, because it has brought about a lasting transformation in the configuration of power and represents a turning point in the course of history.*"

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GEORGE S. ZAVVOS

Mr Zavvos is currently a Legal Adviser at the Legal Service of the European Commission in Brussels. He has represented the European Commission in over 140 cases at the Court of Justice of the European Union. In this capacity he has also been involved in several financial services reforms, including the European financial supervisory architecture. Mr Zavvos was the first European Commission Ambassador and Head of Delegation to the Slovak Republic from 1994-1997 where he established with the EBRD the first post-privatisation investment fund in Central and Eastern Europe.

From 1990 to 1994 Mr Zavvos was the leading Member of the European Parliament (M.E.P.) on financial services (Rapporteur for the Directive on Capital Adequacy for Banks and Investment Firms as well as the Directive on Supplementary Pension Funds and the Post-BCCI financial stability reforms). In addition, he was Member of the Budgets Committee and Budgetary Control Committee. He was also Member of the Joint Parliamentary Committees European Parliament - US Congress and European Parliament - Russia (Duma).

From 1991-1992 he was Chairman of the Committee for the Reform of the Greek Banking System which introduced in 1992 the first fundamental banking law in Greece, modernising the legal framework for the operation and supervision of banks and aligning it with EU law.

From 1981 to 1990 Mr Zavvos worked at the European Commission's Directorate General for Financial Institutions and Company Law where he was in charge of the drafting and negotiating of the Second Banking Directive.

Mr Zavvos was a Professor at the Solvay Business School of the Université Libre de Bruxelles (1991-1993) and a visiting professor at Queen Mary, University of London (2004 – 2007). He holds an LLB from Athens University and a postgraduate Degree on EU Law from the College of Europe, Bruges, Belgium. He was awarded the title of Doctor Honoris Causa by the University of Economics in Bratislava and the Double Cross of the Slovak Republic. Mr Zavvos is the author of the book 'European Banking Policy – 1992' (1989) and co-editor and co-author of the book 'EU Policies on Banks and Investment Firms' (2007). He has lectured and published extensively on European banking regulation and policy.