FROM BUST BANK BAIL-INS IN NICOSIA TO A BANKING UNION IN FRANKFURT: CAN THE EU MOVE FORWARD?

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"Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity."

(The Schuman Declaration, 9 May 1950)

The latest Eurogroup decision on Cyprus can unfortunately neither be seen as a "concrete achievement" nor as a motor of "solidarity"; and with solidarity largely absent from the picture, one is left but wondering where "that fusion of interests that is indispensable to the establishment of a common economic system" (The Schuman Declaration) has vanished?

There are two levels of criticism which are worth engaging in: (a) the macro-level, concerning the short-sightedness of European technocrats at the time of the creation of the EMU and (b) the micro-level that concerns the specific Eurogroup decision on Cyprus.

Starting with the macro-level, blunders can be dated as far back as the early 1990s when the Treaty of Maastricht laid down the foundations for a monetary union (modelled around a European Central Bank), in the profound absence of an economic union – in terms of both fiscal and banking union, two essential attributes of a sound economic model. Despite the label 'EMU' (Economic and Monetary Union) given to the new project, there was a clear absence of a strictly coordinated economic policy; hence, 'EMU' ended up being a huge misnomer.

From birth therefore, the EMU lacked the basis for an institutional mechanism that could restore economic stability in times of crisis and attract capital investments in times of market uncertainty. As borrowing costs fell dramatically after the introduction of the euro in 1999, in line with Germany's historically low interest rates, new member states had access to great amounts of capital from the ECB and a frenzied borrowing process began (which does not of course let the agents that engaged in this unrestrained borrowing off the hook). In the absence of a European rating agency, the risk and uncertainty caused by this uncontrolled borrowing was not evaluated correctly. Governments found themselves with unsustainable debts and the sole institution of the Eurozone, the ECB, was not able to handle the situation.

Apart from the fact that a European stability mechanism was non-existent (while it should have been established from the beginning), the absence of a single fiscal authority, with the jurisdiction to set a common fiscal policy across the Eurozone, became a most acute problem. The ECB was unable to respond to the crisis through an expansionary monetary policy, as the US Federal Reserve had done a couple of years back. The Fed however, unlike the ECB, had a fiscal authority (the Federal Government) to count on for both short-term and long-term financial control. Such institutions are still non-existent in the case of the EU and highly doubtful whether they are desirable, considering that the EU is not a federal state and a vast segment of European citizens would not want to see it turning into one.

The broader problem that stems from these structural and institutional deficiencies and is currently shaking the system is that the European periphery (and the South more acutely) has now become the unequal bearer of all the economic dislocation that is essentially the product of the EMU's originally flawed design. Ironically, the complex interdependence of this model is at the same time precipitating trade surpluses in Germany, which is now reaping the benefits of the undervalued Euro; so much for the "fusion of interest" model union.

Turning to the micro-level, the current pervasive conviction is that Cypriot banks had got too big for their boots. Up until Greece's economic collapse things did not seem so bad for the Cypriot economy. But this changed dramatically when during Greece's second bail-out package foreign investors holding Greek bonds were forced to take a 'haircut' of up to 70% in the value of their holdings. As the Cypriot Government at the time took the totally off-beam decision to adhere to the Greek PSI (Private Sector Involvement) without requesting a recapitalisation of its own banks, the latter were put on life support. This had huge repercussions on the Cypriot economy, as the banking sector was the backbone of the system. When Cyprus' turn came to request a bail-out deal of €17 billion, the EU decided that in the case of Cyprus the bail-out would be turned into a bail-in, which essentially meant that this time the 'haircut' would be imposed upon the depositors. So instead of attempting to revive the banks, the EU essentially pulled the plug on them.

What made this decision even more unfortunate in the first Eurogroup round on Cyprus is the fact that the €100,000 deposit guarantee was not respected, with the intention to impound 6.75% of the money in the accounts with less than €100,000. Not only was this move ill-advised, but in direct violation of Directive 2009/14/EC (which amended Directive 94/19/EC), according to which the limit of €100,000 became applicable to all aggregated accounts (current account, savings account and other accounts) of one account holder (an individual, a small, medium-sized enterprise or large businesses) at the same bank. The specific Directive was targeted at discouraging depositors from moving their funds from one

EU country to another. This had caused disruptions in financial stability in the past and did not ensure the proper functioning of the Internal Market, as account holders tended to transfer their deposits to banks in member states that enjoyed a higher coverage.

The fact that the Eurogroup presented the levy on guaranteed deposits as a tax so as to evade the EU's own guarantee rules, does not lend legality to the action. Even after the backpedalling on this regrettable decision, which culminated with the second Eurogroup round on Cyprus where it was decided to only 'tax' the over €100,000 deposits, it is doubtful whether the damage has been contained. As the Chair of the European Parliament's Economic and Monetary Affairs Committee Sharon Bowles stated on 16 March 2013, "What else will be blown apart when convenient? All the capital requirements we have slaved over, what about the new recovery and resolution rules? What does this mean for confidence in cross-border banking and resolution and preventing the fragmentation of the banking sector? When the dust has settled on this deal, which I hope it never does, we will see that the Single Market has been sold down the river for a shoddy price." In simple terms, trust in the EU has been shattered.

What made things even worse for the Eurozone was Dutch Finance Minister and President of the Eurogroup Jeroen Dijsselbloem's comment, that the Cyprus bailout could serve as a model for others. The statement ruffled feathers and he soon had to retract it by tweeting that Cyprus was of course a special case! But the damage had already been done. Not only is it a very bad sign when politicians have to take back their own words – let alone when others need to do it for them – but what's even worse is that people will hardly believe them. The message has already been sent: EU bail-ins are a possibility in the 'Euro-family' and this can instigate bank runs. Depositors of the European South will either move their money to the North, or even better outside the Eurozone, or as a solution of last resort hide it under their mattresses, pillows and socks. It is of course unlikely that the Euro will collapse in this way, yet not impossible if similar heists on people's deposits continue in the future.

The obvious way to avoid bank runs in case of bail-ins is by imposing capital controls, as is happening in Cyprus right now. But even this cannot be a permanent policy and cannot prevent or mitigate fears of future bank runs. Moreover, this measure is not in line with EU principles of free capital movements; even worse, such capital controls, which prevent the trading of the currency in Cyprus, can eventually cause huge discrepancies in the currency across Eurozone members. What we might end up with, in other words, is an untradeable Euro in Cyprus being worth much less than a freely tradable Euro in Germany.

It is thus clear that simple economic coordination does not suffice within a currency union. If the EU wishes to preserve the Euro it is imperative to restore lost confidence in its financial system for savers and investors to regain a sense of security. In the absence of a fiscal union – an unpopular scenario as it involves sacrificing state sovereignty on fiscal management – a banking union seems to be the only remaining option for EU policy-makers. This should entail, at a very minimum, an integrated system of supervision in the form of a single supervisory mechanism for banks, based on a single rulebook; at a maximum, a single resolution mechanism to handle bust banks, funded by levies on the sector itself, even though this is difficult as the EU Treaties provide no base for such mechanism.

So in the post-experimental era – and with the Cypriot guinea pig now hardly breathing – the EU should get its skates on and work towards reviving the momentum towards the banking union model. The starting point should be the redress of all the anomalies and institutional weaknesses emanating from the foundations of the EMU structure. The question is whether the EU can provide new impetus to its banking union process, perhaps one day even proving former governor of the Bank of England Mervyn King wrong in that banks are *"global in life but national in death"*. Can the EU ever reach a stage at which this kind of 'death' will not be a national affair anymore?