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A real banking union can save the eurozone

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By Wolfgang Münchau

We have reached a rare moment in the eurozone crisis: I seem to be more optimistic than financial markets. I do not believe that Greece will leave the eurozone and I see a small chance that the June 28 meeting of the European Council will bring agreement on a banking union of sufficient strength.

The idea of a banking union has momentum. Mario Draghi, European Central Bank president, said last week that bank restructurings should be centralised because governments have made a hash of it. Mr Draghi, along with Mario Monti, Italian prime minister, was the driving force behind a discussion on the subject during a recent informal dinner of the European Council.

A previously sceptical Angela Merkel seems to be more open to the idea, but lacks enthusiasm. It was the German chancellor who in 2008 rejected the idea of a pan-European fund to cope with the collapse of Lehman Brothers. At that time, the eurozone took the catastrophic decision that each country must rescue its own banks. That was the day when the eurozone crisis started.

Her reported change of heart can only mean one of three things. First, she may genuinely be ready to negotiate a banking union. Second, she may be ready to go for a fudge. A third explanation is that she wants to say no without appearing to say no, perhaps to deflect blame. If it is anything other than the first explanation, we are in trouble.

For a start, such a union must include almost all the banks. The test of inclusion should be systemic relevance. This should serve financial stability, not competition policy. The bar should be low enough to let in Bankia and the German Landesbanken – in other words very low indeed.

It would take all the systemically relevant banks out of the member states and into the eurozone. The notion of a Spanish bank would cease to exist. Bankia would be in Spain but no longer Spanish.

Gavyn Davies

A banking union would need to include four centralised components: a resolution and recapitalisation fund; a fund for joint deposit insurance; a central regulator; and a central supervising power.

In addition, the two funds – one for recapitalisation and one for insurance – need to be appropriately financed. A bank resolution

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facility should be backed by a commitment of, say, €1tn, which will eventually have to be funded by a joint and several debt security – a eurozone bond. To kick-start this process, one could use the existing rescue umbrella, but this can only be a temporary solution.

The deposit insurance should have no limits. It is probably best to anchor it at the ECB itself – which would be justifiable if and when the bank recapitalisation facility was big enough. Its goal should be to stop the two types of bank run we are seeing right now. The first is sectoral: a run on weak banks, with money routed to strong banks. The second is geographic: a run on banks in weak peripheral countries, with money routed to core countries. In other words, the deposit insurance not only needs to insure deposits, but the euro value of the deposit even if the country leaves.

In depth

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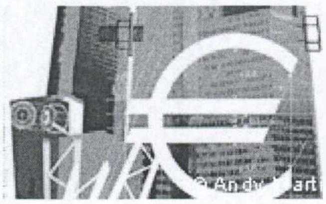

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Both schemes require deep institutional change. A joint recapitalisation fund needs a central supervisor with the courage and power to walk into a Spanish bank and close it down. Deposit insurance must be accompanied by a deep political union. Otherwise, it might create moral hazard by encouraging countries to leave the eurozone in safe knowledge of this guarantee. Without a commitment to further political union, deposit insurance is either ineffective or ruinous. Recapitalisation, insurance and joint supervision therefore go together.

So, a proper banking union is a very big deal indeed. It would be the biggest component of any future fiscal union. But I am not sure that everybody is on the same wavelength. As ever, one should never underestimate the willingness of European politicians to attempt a fudge if they cannot reach a compromise, and pass it off as a historic agreement. To say otherwise would be a triumph of hope over experience.

But at least I have that hope. Unlike six months ago, officials now realise there is no alternative to a banking union. The biggest danger now is that eurozone leaders change their minds. Ms Merkel has not made the case back home. A proper banking union would come as a shock to many Germans, including those in the media. It is still easier to be a pessimist, but I am not yet quite ready to give up what will probably be the last chance to save the euro.

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