the eurozone, this is precisely the option that EU leaders have seized upon as a means to address the crisis.

Their motivation is not high-minded European federalism, however. It is necessity. Labouring under the yoke of indebted sovereigns and the banks that finance them, the 17-member currency union is fighting a crisis that could cripple its financial system. Even positive events – such as Sunday's Greek election victory for a pro-bailout party – give little respite. Big bang "solutions" – from "eurobonds" to bottomless bailout funds – either fizzle or emerge stillborn. Banking union is the latest hope for a fix that puts steel in the eurozone structure, shares some financial risks – but is, it is hoped, acceptable to Germany, the eurozone's paymaster.

"We urgently need to adopt a vision for a fully developed economic and monetary union. The moment of truth has arrived," says Michel Barnier, the EU's top financial regulator. "In acting on our vision we will no doubt have to make a quantum leap to a banking union."

The move started with Europe's central bankers, who in March began publicly calling for integrated eurozone bank governance. Then it moved to regulators and EU leaders, winning enthusiastic backing from the European Commission, France, Italy and even – in parts – Germany.

The politics is moving faster than many expected, especially in the City of London. Last week some thought José Manuel Barroso, European Commission president, over-optimistic when he called for a union by the end of next year. Now EU leaders are discussing bold political steps – taking Europe a good way towards a banking union – within weeks.

"Finally there is a realisation that the banking side of the crisis needs to be addressed, that a banking union is crucial to the sustainability of the monetary union," says André Sapir, a member of the European Systemic Risk Board, the EU's financial stability watchdog. "That has taken a long, long time. But it has come. This realisation must be transformed into concrete actions, very soon."

Yet to give life to a such a federation requires even greater political sacrifices than those made to create the single currency in the 1990s. The political fight is only beginning. And the most difficult issue of all – getting wealthy countries to pay for this new union – is far from being resolved.

1 National tools, continental problem

The sudden urgency is partly down to the turmoil in Spain. A €100bn EU bailout of its banks, proposed on June 11, appears to have backfired. Under existing rules, the EU bank rescue funds must be funnelled via loans to Madrid – a step that piles more debt on to the Spanish government. This helped push its already painfully high borrowing costs to unsustainable levels, dragging Spain a step closer to a full sovereign bailout.

This has exposed structural flaws in the eurozone. Banks operate across borders. But when things go wrong – even in a multi-member single currency club – it is national taxpayers who foot the bill, and national authorities that are responsible. The fortunes of banks and their sovereigns are tightly bound together and, in bad times, that can be lethal.

During this financial crisis, EU taxpayers discovered what it means to underwrite these institutions: some €4.5tn of state aid has been approved to European banks since 2008, equivalent to more than one-third of EU economic output.

Banks, in turn, discovered their dependence on their home country. A bank backed by a weak sovereign pays more to raise money. When sovereigns face fiscal troubles, banks also suffer as they are big buyers of their home government's debt – last year more than 60 per cent of Irish, Portuguese and Greek bonds were held by domestic banks.

In the aftermath of the credit bubble, these ties formed a destructive loop that has bedevilled the eurozone, describing a path to ruination where cash strapped banks eventually drag down the cash strapped sovereigns that were supposed to rescue them.

These ties also hamper the solution. National authorities can be too close or proud to diagnose banking problems early, too reliant on banks as customers of their debt, or too fond of national champions.

"Call it capture, economic nationalism or financial repression," says Nicolas Véron of the Bruegel think- tank. "It takes different forms in different countries. But in times of crisis it makes it very hard for national politicians to take the necessary steps."

The result: confidence is shot. Banks are refusing to lend to each other and retrenching behind borders. Bank customers are partaking in an alarming slow motion bank run, shifting deposits from Greece or Spain to relative safer countries. Since 2009, the deposit base of Greek banks has shrunk by more than a third.

2 European banks, European guarantees

In its purest form, a banking union strips national governments of control. Federal EU authorities would monitor bank operations, police rules and step in when an institution is struggling. At the same time, taxpayers pool risk, so the burden of underwriting a bank is spread across Europe, rather than falling on those taxpayers in a bank's home country.

There are various institutional designs for how this could be achieved. But, in essence, it involves sharing power and liabilities across borders. National supervisors could still play a role in monitoring banks, especially smaller institutions. But ultimate power would rest with the federal body, which could be the European Central Bank or the European Banking Authority, the London-based pan-European supervisor. Mr Barnier says this common supervision "is crucial for trust between countries" so risks on resolution and deposit insurance can be shared.

This new supervisor would need clout to overrule elected governments. With the powers envisaged, a single EU resolution authority could decide to windup an Austrian or French bank, impose losses on its private investors, and dismantle the institution – all over a weekend and against the wishes of national governments.

For a full-blown union there must be a common backstop, to make good on deposit guarantees and pay for bank resolution. This is the hardest part. Brussels is pressing for a single fund, replenished through levies on financial institutions. But even after 10 years of paying dues, this is unlikely to cover the costs of a major systemic crisis, or insure some €5tn of eurozone household deposits. So-called bail-in powers – the ability to write down unsecured creditors to failed banks – would reduce the burden on taxpayers. But as proposed, it would not be in place until 2018.

So an implicit public guarantee would likely remain – effectively an open-ended commitment from taxpayers in Germany and other creditor countries to stand behind the banks in Spain, Italy or Portugal. "And proposing that to German voters would be political suicide," says one senior European diplomat.

3 Share controls, then share risk

The political obstacles are legion. But the critical dispute is over sequencing. Before exposing German taxpayers to foreign liabilities – such as deposit insurance or direct stakes in banks – Angela Merkel, German chancellor, wants federal controls over national banks and a fiscal union. In other words, some shared control of national tax and spending.

Banking union is not ruled out. But Ms Merkel last week rejected "apparently simple ideas about mutualisation", warning that "Germany's strength is not infinite".

This takes too long for the vulnerable periphery countries who want Germany's heft deployed immediately. Berlin's demand to first establish controls makes sense, say those working on the blueprint, but "you need something fast that my grandmother would understand". "My grandmother doesn't understand supervision," adds the official. "She understands deposits and whether hers are safe."

Money is not the only issue. Ceding sovereign power over banks was once unthinkable. Even if that political step is taken, it will involve tremendous cultural upheaval. "You have some very entrenched national authorities which have no intention of giving up power," says one senior European regulator, specifically referring to the Dutch, French and German regulators.

Others worry about the accountability of concentrating such power with the ECB. "Do they seriously want to make it even more powerful?" says one senior European official. "They'd better think hard."

There are other wrinkles. Berlin is open to EU supervision, on one condition: excluding its politically powerful regional savings banks, arguing they are not systemically important. Yet it

was exactly these kind of regional banks in Spain that forced Madrid into a bailout. Other countries will no doubt be pressing for their champions to receive special treatment.

4 Long-term vision, urgent crisis

Building a functioning banking and fiscal union could take five to 10 years, much like the creation of the euro. It is time policy makers do not have. With Spanish banks threatening to bring down the eurozone's fourth-largest economy, a summit of EU leaders next week will need to demonstrate decisive progress.

This could come, in part, with a political declaration, setting a long term path to banking union. More contentious are the, still undecided, concrete short-term steps.

France is proposing the most ambitious plan, a crisis-fighting blueprint that goes a significant way towards banking union and one that has already won the backing of Italy and Spain. President François Hollande, buoyed by securing a parliamentary majority at the weekend for his Socialist party, wants to charge the ECB with supervision of large banks. This would be a big sacrifice of sovereignty. But it is a political move that could be enacted, under EU treaties, with a unanimous vote. It could, in theory, be done in an evening.

More difficult is the financial side. Mr Hollande wants the European Stability Mechanism, the €500bn eurozone rescue fund due to come into force next month, to recapitalise banks directly, rather than via loans to states. The ECB, as the eurozone bank authority, or a related agency would decide when to use funds, what amount was required, and on what terms stakes should be sold down.

Berlin is reluctant to support this. In part, it fears the direct exposure to financial risk that German taxpayers would face and partly because of the moral hazard of the EU offering a safety net for banks, without tough conditions imposed on the sovereign.

Those brokering the deal hope Ms Merkel will be enticed by a pledge that all countries – including France – would first ratify the German-inspired fiscal compact agreed last December that would incorporate spending controls in the constitutions of eurozone member states. There would also be a road-map to fiscal union, including drawing up strict new EU laws before the end of the year. "Treaty change would be Merkel's Christmas present to German voters," says one senior European diplomat. Other senior officials are unconvinced this will be sufficient, saying Berlin's demands for sweeping political reform may simply mask "an unwillingness to move".

There is even less hope for a deal on the most sensitive issue: common deposit insurance. Ms Merkel's objections mean that, at least for now, Europe's main safety net would be cheap ECB loans to suffering banks. This would not cover losses after a collapse, but would address a run on solvent banks triggered by the weakness of a country. Were the ECB empowered to ensure banks are solvent, it could take up this liquidity provision role with more confidence.

5 Eurozone union, British separation

The political troubles do not end at the eurozone. George Osborne, chancellor of the exchequer, supports the urgent creation of a banking union that is the "natural consequence" of a single currency. The catch: the UK, home to Europe's most important financial centre, would not take part. To Mr Osborne, the banking union is not the inevitable conclusion of Europe's single market.

Indeed, the chancellor is vowing to obtain "safeguards" to stop eurozone banking union countries laying down terms to London. Should a fresh treaty-change proposal emerge from Berlin, it promises a repeat of the fruitless plea from David Cameron, prime minister, for legal protections for the City at last December's fractious EU summit, which ended with Britain refusing to sign the new fiscal treaty. Mr Osborne said such safeguards were now "more relevant than ever".

This baffles officials in Brussels and Berlin, who wonder why Britain shows no interest in sharing the taxpayer burden of underwriting some of the world's biggest banks, or in mutualising its own deposit guarantee scheme, which is some £20bn in debt. "The Brits have no leverage," said one diplomat involved in the talks. "Zero."

Others in the UK see new potential threats to the City if eurozone integration continues. Andrew Tyrie, chairman of the House of Commons treasury select committee, believes that the single currency area could become a more attractive destination if the ECB were to operate as a powerful lender of last resort, as the Bank of England or the US Federal Reserve do. Indeed, Mr Barnier argues that a banking union of 27 states is "ultimately in the interest of the City".

A more short-term issue is that a eurozone banking union would crystallise the idea that power dynamics in the EU are changing and fuel the case for a British referendum on its European future.

David Ruffley, a Conservative member of the treasury select committee, says: "If anyone thinks there should be a tightening of the noose of over-prescriptive EU financial regulation – and that parliament should accept it – they have another thing coming."*Additional reporting by Patrick Jenkins*

You may be interested in

Greek index soars on pro-austerity party

World awaits Greek election fallout

Talks begin to build coalition in Greece

Euro's Greek honeymoon shortlived