

**The
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Europe's banking union

A la carte and half-baked

Why not build a new European currency on inadequate foundations? It worked so well the first time...

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WHEN Mario Draghi unveiled his plan to do “whatever it takes” to save the euro, he sensibly combined carrot with stick. Countries that wanted the European Central Bank (ECB) to buy their debt in secondary markets would have to embrace a reform programme. Mr Draghi, the ECB's president, was mindful of “moral hazard”: the danger that debtor countries would let discipline slip once the pressure was off.



It turns out, though, that moral hazard affects creditor countries as well. The announcement of the Outright Monetary Transactions (OMT) programme last year helped euro-zone bond markets recover their poise. Despite short-sighted objections to the OMT programme from Germany's Bundesbank, which will be aired in a constitutional-court hearing next week (see [article](http://www.economist.com/news/finance-and-economics/21579022-legitimacy-doctrine-calmed-panicky-markets-challenged-bench) (<http://www.economist.com/news/finance-and-economics/21579022-legitimacy-doctrine-calmed-panicky-markets-challenged-bench>)), it has been a remarkable success. But it also eased the pressure on creditor countries to push ahead with the institutional reforms required to make the euro area stable.

In June 2012 Europeans agreed to start creating a banking union to break the pernicious link between weak banks and enfeebled sovereigns. But Germany, the zone's principal paymaster, and others have since softened this commitment. The joint paper presented on May 30th by Chancellor Angela Merkel and France's president, François Hollande, is the latest evidence (see [article](http://www.economist.com/news/finance-and-economics/21579024-half-hearted-banking-union-raises-more-risks-it-solves-till-default-do-us) (<http://www.economist.com/news/finance-and-economics/21579024-half-hearted-banking-union-raises-more-risks-it-solves-till-default-do-us>)). A true banking union requires three pillars: a single

supervisor; a single resolution authority, with access to common backstop funds; and a joint deposit-insurance scheme. The French-German plan is to use one-and-a-half pillars and pray the edifice stays up.

Unmade in Germany

There has been some progress since last June. The ECB is preparing to become the single supervisor of the region's bigger banks next year. The central bank is best-placed to assess the health of Europe's lenders and to rise above national interests. To be effective, however, a supervisor has to be able to enforce its will. That means setting up a resolution authority that can intervene directly in failing banks, allocating losses among shareholders and creditors, and if necessary, supplying the public funds required to make good outstanding shortfalls.

The Germans, fearing their taxpayers would be liable for other countries' banking woes, have been pushing for a system of national resolution authorities that follow harmonised rules and use their own funds. That isn't enough. Before the ECB takes over, it will conduct yet another stress test of European banks. Assume it finds holes in banks' balance-sheets that cannot be filled with fresh private capital. The German model would throw the ball to national authorities. Weak states risk finding themselves in the same position as Cyprus: tempted to ignore the problem if they can, forced to take on more debt or impose deep losses on creditors if they cannot.

Imposing losses on the creditors of bust banks is the right thing to do. But there is a risk to stability if it is seen as the only way to fill capital holes during a crisis, because it encourages short-term creditors to pull their money out of banks. Even insured depositors may think about fleeing if their government is seen as weak: Cyprus flirted with imposing losses on them.

Hence the third pillar, sadly ignored in the Franco-German plan: a joint deposit-guarantee scheme in which the costs of making insured depositors whole are shared among euro-zone members. Annual contributions from banks should cover depositors in normal years, but they cannot credibly protect the system in meltdown (America's prefunded scheme would cover a mere 1.35% of insured deposits). Any deposit-insurance scheme must have recourse to government backing. The Germans don't like that. But the banking union—and thus the euro—will make little sense without it. In this case, one-and-a-half out of three is a complete failure.

From the print edition: Leaders