



# CER Bulletin

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# Banking union – or Potemkin village?

by Philip Whyte



Since mid-2012, the eurozone crisis has been in remission. The period of relative calm which has prevailed since then has not been the product of an upturn in economic fortunes: until the recent summer uptick, the eurozone had suffered six consecutive quarters of declining activity and rising unemployment (a result in part of synchronised fiscal austerity across the region as a whole). Instead, the period of peace has reflected two factors: the increased willingness of the European Central Bank (ECB), under Mario Draghi's presidency, to act as a lender of last resort to governments; and a belated recognition by European leaders that the eurozone suffers from design flaws that need correcting. Sadly, the success of the first factor appears to have had unfortunate consequences on the second.

A design flaw that was not spotted by critics when the eurozone was launched, and that only became apparent after the 2008 financial crisis, was the instability of a fiscally decentralised currency union backed by a limited mandate central bank. This configuration, it turned out, gave rise to stresses in the eurozone that did not arise in the US. The most destabilising of these was the emergence of 'doom loops' in which fragile banks and fiscally weak sovereigns undermined each other. Reducing member-states' vulnerability to these spirals required the eurozone to establish a banking union. The trouble, however, is that the ECB's success in lowering government bond yields in countries like Spain and Italy appears to have reduced the

sense of urgency felt by European leaders to build a banking union.

Constructing a banking union was never going to be an easy task, not least because it raises the same underlying political sensitivities as Eurobonds (an idea that was abandoned by EU leaders for being too far ahead of its time). The original blueprint for a banking union outlined by Herman Van Rompuy, the president of the European Council, in June 2012 envisaged four pillars: a common authority to supervise banks across the eurozone; a single resolution authority to restructure or wind up insolvent banks; a joint fiscal backstop to recapitalise banks; and a deposit protection scheme jointly funded by eurozone

members. In effect, this blueprint recognised that key functions relating to the banking sector needed to be 'Europeanised' if the eurozone was to be placed on a more stable footing.

It would be churlish to deny that some headway has been made since the Van Rompuy proposals were originally set out. Good progress, for example, has been made in establishing a joint eurozone banking supervisory authority – or 'Single Supervisory Mechanism' (SSM) in EU jargon. The debates in late 2012 about which banks should be supervised by the ECB have now been settled. The ECB will assume day-to-day responsibility for supervising the 150 largest banks in the eurozone, and "ultimate responsibility" for the remaining 6,000 or so small and medium-sized banks. Day-to-day supervision of the latter, however, will continue to be exercised by national authorities. Following a positive vote in the European Parliament on September 13<sup>th</sup> 2013, the SSM should be up and running in 2014.

Progress on the other pillars, however, has been less impressive. A common eurozone deposit protection scheme is not yet on the agenda, and will not be any time soon. A joint fiscal backstop to the banking system is also a long way off. True, European leaders have agreed that the eurozone's bail-out fund, the European Stability Mechanism (ESM), should be allowed to recapitalise banks directly. But the funds allocated to that end have been capped at €60 billion – a tiny sum given the likely scale of bank losses that have yet to be recognised. In addition, for every euro the ESM uses to recapitalise a bank, it will have to post two as collateral to preserve its credit rating. Since this will reduce the ESM's total lending capacity, it will be a disincentive to use the ESM for recapitalising banks.

Finally, the Commission's proposal to create a Single Resolution Mechanism (SRM) has run into strong opposition since it was tabled. Several countries have contested the proposal's legal base – a single market article that would avoid the need for treaty change – and argued (probably rightly) against handing responsibility for resolving banks to the European Commission. Germany, for example, has argued for a looser system located outside Brussels, focused only on the 150 or so largest banks, and based initially on co-operation between national authorities (not on the writ of a supranational body). Since EU business will be disrupted in 2014 by European elections and the end of the Commission's term, agreement on the SRM could be delayed until 2015 if it is not concluded before the end of 2013.

The banking union is still a work in progress and it is probably premature to prejudge its

final shape. But what the eurozone seems to be inching towards is a structure in which banking supervision is partially Europeanised, but the various fiscal backstops to the banking system remain overwhelmingly national. To put it differently, the eurozone will continue to be a currency union shared by seventeen national banking systems, rather than a currency union with a shared banking system. Does it make sense to call such a decentralised structure a banking union? The answer is no. If the purpose of a banking union is to break the lethal interactions between fragile banks and weak sovereigns, it is doubtful whether a structure as decentralised as that which seems to be emerging will do so.

*“The structure which is emerging may reflect political realities in the eurozone, but it does not look like a particularly stable one.”*

The eurozone already starts with a handicap relative to the US, because it does not have a common debt instrument that serves as a risk-free asset for banks across the currency union. Eurozone banks therefore remain highly exposed to the sovereign debt of the state in which they are incorporated – and the price of that debt still varies widely across the currency union. The emerging banking union will do little to alleviate this weakness. Member-states that experience banking crises will still be susceptible to sovereign debt crises. The absence of a common deposit protection scheme will make individual states more vulnerable to bank runs. And if the task of resolving non-systemic banks is left in national hands, the ECB will find it hard to force (or encourage) the closure of insolvent institutions.

The eurozone, in short, is building an edifice which looks like the exact reverse image of the US's. The US combines a highly fragmented structure for banking supervision with a set of critical functions that are carried out at federal level – from deposit protection, to resolution, recapitalisation and debt issuance. The eurozone, in contrast, is building a structure that partially federalises banking supervision, but leaves the remaining functions mostly in the hands of the constituent states. The structure which is emerging may be that which best reflects political realities in the eurozone, but it does not look like a particularly stable one. Further progress will have to be made if the eurozone is to become a stable currency union with a single banking system.

Philip Whyte  
Chief economist, CER

# Europe cannot make up its mind about the US pivot

by Rem Korteweg



Two years ago the United States announced a renewed focus on the Asia-Pacific. Its strategic rebalance – also known as the ‘pivot’ – is driven, among other things, by worries about security. But the EU and its member-states are confused about what this American shift means for their security policies. At stake is the direction of European policy towards Asia, and crucially, how Europe sees the future of the transatlantic relationship in the Asian century.

Despite some early attempts to co-operate, Europe has failed to develop a coherent policy in response to Washington’s initiative. The US put the ‘pivot’ on the agenda of the last EU-US summit in November 2011, and the transatlantic partners agreed to increase their “dialogue on Asia-Pacific issues and co-ordinate activities”. In July 2012, at the ASEAN Regional Forum (a meeting of Asian leaders including the US and EU), a declaration of intent was signed between High Representative Catherine Ashton and then-Secretary of State Hillary Clinton. The declaration mentioned that the US and EU could work together on regional issues such as maritime security, non-proliferation, cyber security and counter-piracy. However, there has been little follow-up. Informally, a group of French, British, German and Italian officials and US State Department counterparts regularly compare notes on Washington’s security policy in Asia, but this is more an American one-way street, than a strategic dialogue.

The lack of momentum partly stems from this year’s changes to President Obama’s foreign policy

team and subsequent European uncertainty about what the Americans expect from Europe on Asia. But the main reason is that Europe has not made up its mind about the pivot. There are four distinct – but not mutually exclusive – sets of ideas that divide policy-makers in the EU and its member-states.

A first set of ideas holds that Europe should pivot together with the United States. The EU’s guidelines for foreign and security policy in Asia – updated in 2012 – embrace this: “The EU has a strong interest in partnership and co-operation with the US on foreign and security policy challenges related to East Asia.” Kurt Campbell, the former US Assistant Secretary of State for East Asian affairs, favoured this approach, and the declaration by Ashton and Clinton notes that Europe and the US can reinforce each other’s positions. ‘Pivoting together’ would give positive momentum to a transatlantic security relationship increasingly characterised by growing US criticism of declining European burden-sharing in security affairs. This could lead to common

contributions to maritime security and missile defence, or to intensifying security dialogues with Asian partners, such as Japan and Korea, perhaps through NATO. The UK, for instance, has deployed a Royal Navy frigate to the region to contribute to maritime security, and NATO's secretary-general visited Japan and South Korea in April 2013. However, many European governments say they may be reluctant to give anything more than diplomatic support to Washington in Asia.

A second group agrees that Europe should focus on Asian security issues – notably because trade disruption due to Asian territorial disputes could upset a fragile European economy – but that it should do so independently of the US. It argues that Europe's position in Asia differs from that of the US, and that it should avoid entanglement in the emerging great power competition between America and China. Besides, the US and EU compete for Asian trade and investment. Europe is also viewed differently in the region; Japanese and Philippine officials believe America's security presence is necessary to balance China's rise, while they see Europe primarily as a trading partner. During his visit to Jakarta in August 2013, France's minister of foreign affairs, Laurent Fabius, announced a French 'pivot' to Asia that would focus on diplomacy and trade. Asia hands at some European ministries of foreign affairs and in the EEAS (the EU's foreign policy arm) like to say that what gives Europe a unique voice in Asia is precisely that it is not the United States. They suggest that Europe should try to strengthen regional institutions, such as ASEAN, and deepen economic relations. Complementarity with a US agenda would be a bonus. Aside from France, Germany's trade-driven approach to Asia also fits this mould. NATO would only have a very limited role at best.

Even if European governments share American concerns, it does not necessarily mean that Europe should play an active role in Asian security. According to a third school, Europe is a regional actor, not a global power. In light of European economic and military constraints, as well as European security priorities, it should instead focus on its neighbourhood, particularly in the south. A new transatlantic bargain would emerge: by focusing on the European periphery, Europeans would allow the US to shift its attention elsewhere. NATO and EU officials often make this argument, and it is supported by the UK's defence minister, Philip Hammond, who said in Singapore in June that Europe needs to focus on its "own backyard as our contribution to a greater United States focus upon the Asia-Pacific region" (even though he also favours a stronger UK role in Asia). European economies that are less reliant on trade

with Asia, such as Spain or Belgium, are equally amenable to this argument. In particular, southern European countries – which fear spill-over from developments in North Africa – back it for reasons of national security. A transatlantic division of labour however, raises questions of practicality: Can Europe secure its neighbourhood without US support? It also risks weakening the transatlantic bond over time.

*“There are four distinct – but not mutually exclusive – sets of ideas that divide policy-makers in the EU and its member-states.”*

A fourth group argues that European security is a casualty of the US pivot. They point to US defence budget cuts and a concomitant military realignment which has reduced the US military's presence in Europe. The last US tank has left European soil, as has the last anti-tank aircraft. In March 2013 the US said it would not deploy the fourth phase of a planned European missile shield (although it is helping to build the first three phases), but announced it would boost Japan's protection against a North Korean ballistic threat. Central and Eastern European governments that feel threatened by Russia's assertive foreign policy have expressed their concern. Unsurprisingly, Estonia and Poland are among the few European NATO allies that are increasing their defence spending. These states urge NATO to re-emphasise its traditional role in collective defence, and are unconvinced that other European states could credibly replace a US withdrawal.

To date, a confused mixture of these four perspectives has produced European prevarication, some national bilateral efforts and a focus on short-term trade promotion in Asia. Lack of ambition and humility may be an accurate description of the current state of the European strategic debate, but Europe is risking irrelevance.

Two strategic questions must be considered. How can the EU and its member-states contribute to a balance of power in Asia that is conducive to European security interests? And how will Europe's position on Asian security affairs affect its relationship with the US? Another EU-US summit is long overdue, and Europe should start formulating answers. In December, European heads of state will discuss the state of Europe's defence and security policy; the pivot should be on the agenda as well.

Rem Korteweg  
Senior research fellow, CER





EU ministers will put years of political wrangling behind them this autumn when they sign off a new set of rules for the Schengen area. The 26-country travel zone was tipped into political turmoil in 2011 when, during the Arab Spring, France temporarily re-imposed border controls with Italy over a trickle of Tunisian migrants crossing their shared frontier. (An exasperated Nicolas Sarkozy would later declare that “*Schengen ne marche pas*” during a televised election debate with François Hollande.)

Though trivial, the Franco-Italian tiff was symptomatic of evident tensions between Schengen states throughout 2011 and 2012. Anti-immigrant feeling seemed on the rise with far-right groups wielding political influence in the Netherlands and Sweden, and a half-serious attempt to re-introduce customs controls in Denmark. Greece – long the weak link in Schengen’s shared external frontier – had to have its Turkish border manned for months by Frontex, the EU’s border agency, and accepted €100 million in European funds to create a proper system for granting political asylum. Meanwhile, Schengen members looked on anxiously as Bulgaria and Romania were set to join by December 2012, despite persistent concerns over the rule of law in both countries.

How did all this drama play out? EU leaders had already instructed their interior ministers to re-visit Schengen’s rulebook in summer 2011. (Every EU country is a member or hopes to be, save Britain and Ireland; Iceland, Norway and Switzerland are also in.) Some

in the Union’s Justice and Home Affairs (JHA) Council wanted more leeway to re-introduce internal borders following events like the Arab Spring. Current rules allow for this only in true national emergencies or to provide security for major sporting tournaments. But the European Commission demurred, floating instead a heroically unlikely proposal that would allow national controls only if it first approved them. A year-long stalemate ensued, as the European Parliament blocked other JHA business in an attempt to force ministers to yield to the Commission and hence expand its own powers in the process.

Ironically, it was Ireland, a non-Schengen country, which resolved the affair early in 2013. As president of the JHA Council, Justice Minister Alan Shatter brokered a compromise to give the Commission the lead in evaluating standards at Schengen’s external frontiers from 2014 onwards, and to recommend if particular countries should face suspension. Effectively, the Commission will monitor Schengen border controls in a similar

way to how it assesses judicial standards and the rule of law in Bulgaria and Romania.

Neither of these two countries will now join the passport-free zone until at least mid-2014, and then by the abolition of air borders only. Among other reasons, their entry prospects were badly undermined by a nasty constitutional crisis involving Romania's president, Traian Basescu, and the prime minister, Victor Ponta, in 2012. Although disappointing for ordinary Bulgarians and Romanians, the affair represented a reprieve for the passport-free zone. Given its other problems, Schengen was ill-prepared for enlargement.

The Schengen area got lucky on other fronts, too. Sarkozy's tough stance on immigration could not distract attention from his economic record and he failed to win re-election. Under Hollande, France is no longer a vocal critic of passport-free travel. Similarly, the anti-Schengen Dutch Freedom Party (PVV) lost their position in the Netherlands' governing coalition in September 2012. And the Greek situation gradually stabilised, thanks partly to some surprising bilateral border co-operation between Ankara and Athens, but also, less pleasantly, to the latter's policy of locking up anyone found crossing the border illegally in detention centres, built mainly with EU money.

What of Schengen's prospects? On some fronts, the outlook is encouraging. The EU has rolled-out two cross-border databases and an information network to link up the different Schengen countries' police and border forces, maritime patrols and consular services. But profound challenges remain. The situation in Greece remains very serious, with tens of thousands of asylum applicants awaiting a hearing.

Unauthorised migrants from Africa and the Middle East (and as far away as Bangladesh and China) have switched their attention to the Greek islands or are attempting to cross from Turkey into Bulgaria.

This year's good summer prompted a considerable rise in the number of 'boat people' arriving to all southern Schengen states by sea. Accordingly, Italy wants its 2014 JHA Council presidency to pressure other Schengen members for more EU 'solidarity' in policing the complex Mediterranean border. Co-operation with Turkey is a critical piece of the puzzle. Yet talks between the Commission and Ankara on a deal to repatriate unauthorised migrants in return for a roadmap towards Turkish visa liberalisation are getting nowhere.

Meanwhile, Germany, Sweden and the Netherlands regret easing Schengen visa restrictions with several Western Balkan countries in 2009. Their officials complain that they now receive more asylum applications from Roma minorities there than from Syria and Afghanistan combined. Several Schengen governments may push the Commission to re-introduce visas with Serbia, Macedonia and Montenegro in 2014.

Hence the passport-free zone is likely to be tested again by various forms of political drama next year, due to unfinished business with Bulgaria and Romania, as well as Greece, Turkey and the Western Balkans. But by weathering the storms of 2011-13, Schengen has proved itself a stubbornly resilient project.

**Hugo Brady**  
 Senior research fellow, CER

## CER in the press

### **Le Monde**

15<sup>th</sup> September 2013  
 For Charles Grant, director of the CER, "Germany is the big problem" for European security policy. The reason being that it either stays neutral or defends its narrow interests.

### **The New York Times**

5<sup>th</sup> September 2013  
 The vote in Parliament "could turn out to be the signal for a strategic shift in favour of insularity," said Ian Bond of the CER. British lawmakers risked "sending the message that in the future the UK will be content to stay on the

sidelines, regardless of what is happening in distant lands."

### **The Daily Telegraph**

4<sup>th</sup> September 2013  
 "Europe, it seems, has become anaesthetised to bad news," says Simon Tilford, deputy director of the CER. "The reality is that the Spanish and Italian economies will shrink by a further 2% in 2013. Greece is on course to contract by an additional 5% to 7% and Portugal by 3% to 4%"

### **The New York Times**

2<sup>nd</sup> September 2013  
 "During the entire two years,

the EU was seen as an honest broker [in Egypt]. Maybe [Catherine] Ashton could have used that leverage more than she did," said Rem Korteweg, of the CER.

### **Reuters**

1<sup>st</sup> September 2013  
 "[The EU] is like playing Jenga," said Hugo Brady, a senior research fellow at the CER. "If someone pulls out the wrong block, the whole thing collapses."

### **The Financialist**

15<sup>th</sup> August 2013  
 "This is not the first such

initiative to free up transatlantic trade and investment, and all previous initiatives have resulted in failure," said Philip Whyte of the CER.

### **The Wall Street Journal**

22<sup>nd</sup> July 2013  
 "The idea that Germans would even get backing from other Europeans [for G20 mandatory debt targets] was rather fanciful, and the idea that Americans would go along with targets was far-fetched," said Simon Tilford of the CER. "...More people are questioning whether austerity in Europe has been self-defeating," he said.

## Recent events



### 18 September

Launch of 'The future for Europe's economy: Disaster or deliverance?', London  
With Paul De Grauwe, George Magnus, Thomas Mayer and Holger Schmieding



### 12 September

Breakfast on 'Can energy policy promote competitiveness and protect the climate?', Brussels  
With Günther Oettinger, European Commissioner for energy

## Forthcoming publications

Is immigration a reason for Britain to leave the EU?

*John Springford*

How to build a modern European Union

*Charles Grant*

*With Katinka Barysch, Hugo Brady, David Buchan, Clara Marina O'Donnell, John Springford, Stephen Tindale and Philip Whyte*

The 2014 European Parliament elections: Why political parties should not choose the next Commission president

*Heather Grabbe and Stefan Lehne*

Europe needs to catch up on carbon capture and storage

*Stephen Tindale*

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