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Responsibility of the ECB in managing the European Debt Crisis: Towards a European Banking Union?

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ABSTRACT

The European Banking Union is already under way in the EU. It is a proposal born in connection with crisis management efforts in the Union. It is believed to be the ultimate response to the sovereign-bank link, which has contributed to the crisis. The key actor in the effort to establish a Banking Union is the European Central Bank (ECB). However, the ECB derives its legitimacy from its limited mandate. While the creation of a Banking Union is a necessary step towards the resolution of the crisis it is also perhaps a step, which requires the ECB to exceed its mandate. It is argued that the Bank must find ways to run the Banking Union while preserving its legitimacy. This is a difficult task. The Banking Union project must quickly overcome legal and political barriers and bring an end to the financial recession which is severely affecting the citizens of Europe.

KEY WORDS

European Central Bank, Recession, European Union, European Monetary Institute, Banking Union

1. Introduction

The financial crisis broke out in Europe in 2008 following a sovereign debt and banking crisis. It is now affecting the whole region having detrimental social and political effects on the citizens of Europe as well as economic effects on its common currency and banking system. EU policy makers have struggled to find adequate responses to the crisis. Within this context, the European Central Bank (ECB) has and continues to be a crucial player but also one with questionable legitimacy. The Bank today fronts the most far-reaching and crucial reforms in the Union after the introduction of the common currency. The Bank is the central actor in the creation of a European Banking Union. As with most of the newly introduced European reforms the Banking Union is a project born in connection with crisis management efforts. It will place all European banks under the auspices of the ECB and subject them to common regulation and supervision as well as to a common resolution mechanism. This article understands this initiative as part of a broader attempt to combine monetary integration with political integration. For the most part, the proposal for a Banking Union has given rise to positive reactions but there are problems. The ECB has adopted measures for which the legitimacy has been seriously challenged. It is confronted with a dilemma between legitimacy on the one hand and effectiveness in dealing with the crisis on the other. Will the Banking Union ease these problems or will it exacerbate them? This article constitutes a discussion of the above issues while providing a detailed historical and institutional background of the ECB and its response to the crisis so far. The paper proceeds as follows: Section 2 constitutes a short introduction to the Union's economic and monetary history and introduces the main institutional aspects of the ECB. Section 3 presents the major dilemma between effectiveness and legitimacy that the ECB is currently confronted with. The main argument is that the Union's constant refusal to understand the Bank as a political actor (as opposed to merely a body of technocrats) has ended up undermining the legitimacy of the Bank and monetary

union. Section 4 proceeds with a discussion of the ECB's role and response during the crisis. This section serves as an introduction to the need for the creation of a Banking Union. Sections 5 and 6 deal with the difficulties inherent in the relevant proposal while they argue that the Banking Union may be a key initiative in striking the desirable balance between legitimacy and effectiveness in the actions of the ECB. However, it is argued that the Banking Union is itself not immune from legitimacy challenges (section 7). The final section (8) concludes that while the Banking Union is an important step towards the resolution of the crisis in the region at the same time the ECB must be very cautious to preserve its legitimacy and remain within its mandate as prescribed by the Treaties.

2. European Monetary and Economic History

2.1. The EU and ECB: Pre-crisis era

The ECB was established on 1st June 1998 and was charged with the responsibility of establishing a single monetary union for the member countries of the EU.[1] Its launch was the result of a process of economic and monetary integration that began in the 1950s with the combined efforts of Jean Monnet and other European political actors. The process acquired vital impetus with Jacques Delors' committee report of April 1989 which recommended the establishment of a European economic and monetary union.

The report of Delors' committee proposed three stages for economic convergence in Europe. Stage one which commenced in 1990, was characterised by open cross-country capital flow and convergence of central banks of member countries. Stage two began early in 1994 and was marked by the introduction of ECB's predecessor namely of the European Monetary Institute (EMI). EMI was established to strengthen the individual central banks and to foster integration and coordination of monetary policies. Stage three which began in 1999 was characterised by

the fixing of individual currency conversion rates and ultimately by the introduction of the Euro which would be managed by the European System of Central Banks (ESCB).[2]

The initial mandate of the ECB was to supervise and manage price stability in the Eurozone. The ECB's delineation of price stability must take account of the entire Euro area therefore price stability is analysed on the basis of the cumulative price level within this zone. Thus, changes in the monetary policy cannot be framed by addressing only a nation or multiple nations. The policy frame must apply uniformly on the entire Eurozone. Further, the monetary policy of the ECB must target the medium term[3]

The ECB monetary policy understands the sustainability of price stability as the key element through which improved standards of living and economic conditions are to be achieved. Sustaining price stability guarantees that price levels remain equitable, thus increasing consumer welfare and boosting the overall economy. It also alleviates the risk premium on investments within the Eurozone while raising incentives for investors to bring more credit to the Euro industries. A stable and sustainable price level will disincentivize hedging activities and prevent any disturbances to the overall economic growth.

Before the crisis, the ECB undertook its task in a satisfactory manner as inflationary targets were constantly met. Accordingly, the Bank's reputation was strong and so was confidence in the European banking system.

2.2. The EU and ECB: Post-crisis reactions

The significant expansion of the ECB's mandate came as a result of the intensification of the problems surrounding the single currency in 2010.[4] Today, not only has the ECB provided

banks with liquidity and launched government bond purchasing programmes; it has also become a member of the Troika.[5] The latter development means that the ECB participates actively in the formation and monitoring of macroeconomic adjustment programmes (economic conditionality programmes).[6]

The financial recession affected large parts of the region and notably the Union's (and Eurozone's) southern Member States.[7] This region was already confronted with serious financial problems and with significant national sovereign debts. In some cases those were triggered by bank bailouts such as in Spain and Ireland.[8]. The cases of Greece and Cyprus put the final nail in the coffin of a strong Eurozone and robust currency. Those countries inevitably turned to the Union and its institutions for financial assistance.

2.2.1. Cyprus: An example of the inadequacies of EU's response

Cyprus was struck by the crisis as a result of its banking system being disproportionate to the size of the country's economy.[9] This made it difficult for the country to rescue its largest banks. This example of disproportionality between banking sectors on the one hand and national economies on the other is typical of various Eurozone countries (e.g. Luxembourg, Malta, Ireland).[10] Secondly, the example is indicative of the inadequacies of the Union's and Eurozone's response. In reaction to the Cypriot crisis both the EC and the ECB introduced restrictions on capital and payment flows. Such a development is open to question if not borderline illegitimate as it does not comply with article 63(1) of the TFEU which establishes the principle of free movement of capital.[11]

Further, the effects of setting aside the terms of deposit guarantees has been characterised as inappropriate and undesirable not merely on legal grounds but also based on practical considerations. A number of authors have argued that such a development was bound to counteract the restoration of confidence in banks when it was much needed.[12] Most

importantly, the case of Cyprus is emblematic of the thinking of major political actors and serves as a reason to reconsider how the EU will strengthen its banking system.

2.3. Institutional Aspects of the ECB

The legal foundations for a centralised and unitary monetary policy are framed in the various treaties of the EU and its institutions. The ECB was established to regulate, implement and monitor the monetary policy throughout the EU. In 1999, eleven national banks acceded to the ECB. Later, another six EU Member States joined the ECB as participants. The current seventeen members take active part in framing the monetary policy for the EU. The two decision-making bodies that help to frame the monetary policy of the ECB are the Governing Council and the Executive Board. The monetary policy is framed by the Governing Council and implemented by the Executive Board.

New members entering the ECB relinquish their domestic exchange rate policies in order to implement the ECB policies as laid down by the Governing Council. They are free to maintain their fiscal policy mechanisms but face legal obligations laid down in a series of EU Directives and Regulations. These usually refer to the preservation of stability within the Union through strict adherence to the rules. For example, the Stability and Growth Pact based on articles 121 and 126 of the TFEU is a series of legal measures enacted to coordinate national fiscal policies. The reforms were enacted through a number of secondary legislation instruments known as the Six Pack.[13] The Six Pack, inter alia, creates the mechanism of a centralised form of monetary policy while allowing for a decentralised fiscal policy with certain limitations.

To summarise, the ECB's monetary policy is primarily aimed at preserving the Euro's purchasing power by securing price stability within the Euro zone. This mandate is found in

both the primary and secondary legislation of the Union. However, the Bank significantly broadened its mandate as a result of the financial crisis yet the decision-making processes of the Bank remain stripped of any direct or indirect involvement of the European people.

Having discussed some aspects of the history of the EU and ECB as well as the most important of the latter's technical/institutional aspects, the next section will argue that this position not only affects the legitimacy of the Bank but also its effectiveness.

3. The tension between effectiveness and legitimacy of the ECB

The initiative of European policy makers for the establishment of the ECB was aimed at creating an institution which would be independent and most importantly non-political. The ECB was intended to abstain from political decisions and matters of distribution and deal only with technical matters. This is also reflected in its legal foundation found in various articles of the TEU and TFEU.[14] Yet, with the financial crisis in Europe, the Bank found itself involved in political decisions and distribution policy. Political and economic analysts were not surprised to see the financial crisis taking such severe proportions in the European region.[15] The European Monetary Union is one of the few historical examples of the creation of a common currency within a non-politically integrated region.

In broad terms, this reflects the idea that the market can be disentangled from politics. This disentanglement virtually implies that macroeconomic policies can be dealt with merely by technocrats without any involvement of political questions or distributional issues. Certainly, it is not unusual for the EU to present important political questions as purely technical ones and to delegate them to technocrats stripped of any democratic legitimacy.[16] However, in the case of the ECB the lack of democratic legitimacy was exposed when the Bank was called upon to

provide solutions to the financial crisis. Its initiatives and interventions were extremely far-reaching and not based on any sort of democratic legitimation.

Certainly, the European economy was at a state of emergency. This might justify interventions but the Bank did excessively exceed its mandate. The austerity measures demanded and imposed by the Bank especially in Southern Europe cannot be justified on the basis that Europe was in a state of economic emergency. One example of public opposition to ECB's policies is that of Europe's largest trade union federation which charged the ECB with secretly governing domestic fiscal and labour policies while at the same time being unelected and completely unaccountable to European citizens.[17]

It is argued that the reasons for the Bank's lack of accountability can be found in the foundations of the ECB. The financial crisis merely exposed the undemocratic nature of the ECB which was already existent but was apparent until 2008. Indeed, the debate on the Bank's legitimacy was vivid already in the early 2000's when the ECB's main decision-making organ, the Governing Council, was subjected to a reform which eliminated equal voting rights thus distorting the principles of equality, representation and ad personam representation which were fundamental pillars of ECB decision-making.[18] Further, its procedures were opaque regarding the way in which decisions were being reached.[19]

The problem became more obvious after the Bank was required to reach decisions that would mitigate the impacts of the financial crisis and decisions on haircut policies. If non-transparent processes were a minor problem during the pre-crisis era this was certainly not the case when the Bank became confronted with the need to decide on collateral policies regarding the assessment and haircut of securities. These are questions of a political nature impacting heavily on redistributive policies. In other words, the idea that monetary policy decisions are a-political and can be isolated from the political arena and from political conflict, an idea which was

present from the very early days of the Bank is in and of itself deeply undemocratic. It is based on the conviction that monetary policy does not impact on citizens and should thus be immune from their direct or indirect influence.

In a domestic setting, independent central banks perform more or less the same tasks as the ECB does. However, in nation states the independence of central banks is counterbalanced by the strong democratic legitimacy conferred upon the state institutions.[20] By contrast, the debate about the EU's democratic deficit is perhaps more intense than ever. The Bank's lack of legitimacy impacts severely on the legitimacy and credibility of the rest of the EU's institutions including the CJEU, the Commission and also the Parliament. Arguably, the Bank's lack of legitimacy cannot but be understood within the wider framework of the EU's democratic deficit which is exacerbated by the discrepancy between a monetary union on the one hand and the lack of political integration on the other.

Returning to the point that a monetary union is not viable in the absence of a politically integrated one. Political integration is not easily achievable and the EU has been struggling to create it for more than two decades now. A crucial step towards this end should be the integration of domestic fiscal and banking policies. In light of this, the creation of a banking union may prove pivotal not only for the resolution of the financial crisis but also for the restoration of the Bank's legitimacy.

3.1. Why legitimacy matters

Legitimacy matters because people who are affected by a decision should have a say either directly or indirectly in the relevant decision-making process or should at least be able to hold those who took the relevant decision to account. Legitimacy is also important for maintaining public confidence in the Bank and Eurozone. In turn, public confidence is a fundamental requirement for the effectiveness of the ECB's response to the crisis.[21] There is an argument

that because the ECB is de facto incapable of introducing democratic qualities in its decision-making processes it should not be concerned with input legitimacy. Instead, it should focus on output legitimacy namely on the effectiveness of its decisions.[22] This view is rejected on two grounds. First, it is true that the ECB being an independent body cannot make decisions backed by the same democratic legitimacy as an elected entity. Still, this does not justify the extreme opaqueness and the unwillingness of the Bank to make its processes more transparent given especially their broad impact upon the people of Europe. It is argued that the more the ECB legitimizes its processes the more effective they will be. This is so, not least because effectiveness is largely contingent upon public perceptions. If the ECB manages to restore public confidence in it, then its policies are bound to become more effective. This is so, because loss of confidence in the ECB and in the common currency (both on the part of citizens and on the part of bankers) results in the inability of the Bank to shape market expectations. Second, a look at recent Eurobarometers reveals a significant break in European citizens' trust in the Bank.[23] This indicates that the Bank cannot rest solely upon its effectiveness in order to claim legitimacy. Public confidence needs to be restored. The opposite view, that in the future the financial crisis will be regarded as one of 'the major tests that strengthened the legitimacy of the still young central bank' does seem neither to be popular among scholars nor to be confirmed by existing data.[24] In light of this, European policy makers should rethink the prospect of restructuring the institution towards a more input legitimacy-oriented direction. In other words, both input and output legitimacy are of equal importance because they fortify each other. A key question is whether a potential Banking Union would satisfy the demand for an integrated approach to input and output legitimacy or whether it would further undermine it.

3.2. Challenges against the ECB's legitimacy: The example of the OMTs programme and the GCC's reference to CJEU

The ECB's mandate has not been left legally unchallenged. Amidst criticisms against the unprecedented extension of the ECB's mandate the German Constitutional Court (GCC) has decided to refer to the CJEU regarding the legality of the Bank's practices. The GCC's questions concerned a Bank's early initiative taken in 2012 within the context of the constant expansions, namely the Outright Monetary Transactions (OMTs) programme. We will now turn to the basic issues of this judicial challenge.

The Outright Monetary Transactions (OMTs) programme is a legal monetary policy programme launched in August 2012. It concerns monetary policy transmissions in the EU and functions as a restoration of confidence for investors worried about the possibility that the crisis will spread to other EU countries. Analysts held that the recession end is eminent as long as the OMTs programme remained operational.[25] Indeed, although OMTs is certainly no panacea it is often argued that its wise use may function as the ECB's 'magic wand'.[26]

The GCC is not of the same opinion and argues the ECB may have overextended its mandate.[27] The GCC's concern is the EU Treaty which limits the ECB's mandate to the management of EU monetary policy and the safeguarding of EU currency price stability. According to the Treaty, the ECB is not permitted to finance EU governments. The GCC acknowledged that purchasing bonds was a standard financial activity conducted in order for the EU to meet monetary policy needs. However, the GCC argued that purchasing bonds to finance governments was an illegal activity for the ECB to engage in. This raised the question of whether the ECB's purchase of bonds from EU countries was a way of financing governments,[28] and thus violated the ECB's mandate as laid down by the EU treaty. Nevertheless, it is unlikely the CJEU will find against such a major institution as the OMTs. However, the challenge of the legality of the ECB's actions by such a major court weakens and

unsettles the ECB as an institution. The issue is relevant to our discussion as it may further destabilise investors' confidence and jeopardise plans for a robust Banking Union. The issue is also indicative of the general uncertainty surrounding the ECB's practices. How the GCC's reference will reflect upon and affect the plans for a Banking Union remains to be seen.

This section will serve as an overall background to the discussion that will follow. In particular, as will be discussed in the sections dealing with the Banking Union the tension between legitimacy and effectiveness in the context of the ECB apply equally to the initiative for the establishment of a Banking Union. Before moving to that discussion we will examine the development of the ECB's policies during the crisis to provide greater context for the reasons for the establishment of a Banking Union.

4. Development of ECB policies: Responses to the crisis

When the European debt crisis first broke out it was thought to be primarily an Anglo-Saxon issue. Accordingly, it was believed that the Eurozone crisis was the result of collateral damage from a different financial recession.[29] However, the crisis deepened and slowly spread over to other parts of Europe. Various analyses revealed that this debt crisis was the result of a number of long-term problems including lack of supervision and ineffective regulation.[30]

Debt problems were addressed by recapitalising some of the European national banks. In October 2011 the newspapers reported that the leading European banks had to bring in more cash reserves.[31] It is indicative that already in 2011 the IMF was reporting that European banks' balance sheets presented a hole of more than 200 billion EUR because of sovereign debt.[32] In addition, financial experts estimated that debt crisis recovery would require an extra 440 billion EUR. [33]

It is sometimes argued that the ECB could not have predicted the crisis and that putting the blame on the Bank would be extremely unfair as the freeze of money markets is one of the developments that no one had foreseen.[34] Neverthless, it is reasonable to question how the Bank reacted. A review of the responses taken by the ECB in order to handle the Eurozone debt crisis shows that it was comprised of two main amendments, related to standard and non-standard financial policy measures.

4.1. Standard measures and the way towards non-standard measures

The key element in any standard measure of a central bank is reflected in its customary policy rate. In the euro zone this is the lowest bid rate within the measure adopted and is known as 'main refinancing operations'. This is the principal point that needs to be taken into consideration in order to demonstrate the effect of the monetary policy measures over the prices within the Eurozone. Based on this instrument, the ECB lowered interest rates to alleviate price stability related risks.[35]

In the wake of the Eurozone crisis HICP (Harmonised Indices of Consumer Prices) records of growth were still positive.[36] This was because of the ECB's policies aimed at sustaining stability within the Euro system. The positive growth rates continued and by July 2008 they crossed 4% namely double the target set by the ECB. However, by 2013, the HCIP rates went down functioning as a warning that over the medium term the price developments should come under strict control. Early in 2014, the HICP inflation rates remained stable at 0.8% reflecting some stability.

Therefore, the ECB's capability to sustain price stability was being put to the test.[37] The circumstances surrounding the start of the Eurozone crisis led to a decrease in banks' credibility

and to a lowering of the value of liquidity assets. This lead to a belief that only the ECB could bring in external cash and help maintain the liquidity value.

4.2. Non-standard measures

In light of these developments, the ECB transcended the standard measures in the context of interest rate policy and adopted a number of non-standard procedures (known as extended credit support) for restoring the monetary policy. To recap, the Eurozone financial crisis went through two main stages. The first one coincided with the collapse of Lehman Brothers in 2008 and the second one took place in mid-2010 when the sovereign debt crisis set in. By the end of 2011, it became evident that the Euro debt crisis was not being resolved and so non-standard measures adopted by the ECB correspond to each of the above-mentioned stages. During the first phase the ECB made unprecedented cuts in its main refinancing rate bringing it to a historic low (1%). Further, the ECB also moved to a number of non-standard measures which included fixed-rate full allotment which allowed banks to have unlimited access to liquidity; extension of the maturity of liquidity provision (LTROs) with a view to soothing concerns regarding the refinancing ability of European banks; extension of collateral eligibility which allowed banks to refinance larger portions of their balance sheets; currency swap agreements; and finally the CBPP (Covered Bond Purchase Programme) in order to boost the covered bond market namely the main source of financing Eurozone banks.

The second phase is characterised by the introduction of the Securities Market Programme (SMP) focused on enhancing transmission of monetary policy. It required EU policy makers to reconsider and re-evaluate monetary policy as the system that applied up to that point was based on the premise that bond markets were actually in proper function.[38] Also, the European Financial Stability Facility (EFSF) was established to enable mutual financing between European governments with a view to assisting the most troubled Member States. These did not

prove effective. It is not clear whether the relative failure of these measures is attributed to the governments involved (particularly the Greek government) or whether it was the structural inefficiencies of Europe's initiatives which were to blame. Regardless, the general assumption was that assistance to troubled states should be accompanied by measures of explicit conditionality.

Therefore, the ECB finds itself trapped in a serious legitimacy dilemma for the first time. Conditionality implies that assistance will not be provided unless the state in question agrees to relinquish part of its sovereignty and implement measures dictated jointly by the Union and Bank. It is self-evident that governments which abide to conditionality measures virtually have no choice but to do so. In turn, the supranational institutions which impose the relevant measures, and in our case the Bank, are unaccountable to citizens whose lives are severely affected.[39]

In the third phase of re-intensification the ECB moved towards a 'genuine' implementation of the SMP program which according to ECB officials had not been implemented adequately during the previous phase.[40] However, the ECB's actions proved ill-equipped. The sovereign debt crisis which had by then started affecting Italy and Spain intensified as a result of its reinforcement by national banking systems. Weakened bank balance sheets decreased confidence in European national banks which were at the verge of collapse. Soon, the joint sovereign debt and banking crises spread to Eurozone members which had hitherto remained intact. At the same time however, other European banks were in a significantly better position and were operating in an environment of excess liquidity.

The ECB's response to this insecure and uncertain but also largely differentiated banking landscape was to introduce further LTROs; to reduce the reserve ratio to 1%; to allow national banks to accept additional bank loans without former ECB consent; and to promote the creation

of additional credit assessment sources. And yet, a year after the introduction of these measures European banks were still incapable of providing credit while collateral of high quality was unavailable thus weakening the prospects of access to liquidity.

All non-standard measures implemented by the ECB have common attributes. Their objective is to guarantee that breakdowns within specific market sectors will not create interruptions within the transmission process which might in turn have an impact on the prices. Therefore, the non-standard measures are not a substitute but rather act as a supplement to the standard measures.[41]

The adopted measures also reflect that the ECB primarily aims at guaranteeing the effective overall implementation of common monetary policy decisions. Therefore, the non-standard policy measures do not have any impact on the ECB's capability to sustain financial and price stability. Thus, these measures are short-termed both in scope and in nature.

The biggest hurdle for the ECB is to sustain the pace of reform. It must ensure the viability of reforms at a national level, prepare a stronger base for a more secure monetary union while guaranteeing effective implementation of institutional modifications that have been framed or are being framed. Since the Eurozone economy still remains in a state of uncertainty, the ECB must aim at the implementation of its strategies at three distinct levels.[42]

4.3. Future challenges

First, the monetary policy must support the key goals of the ECB while curtailing risks associated with it. However, maintaining a sound and viable monetary policy is not an adequate condition for overall economic recovery. Eurozone members must adjust their national policies in such a way as to abolish all structural barriers to their economic potential and work towards

long-term fiscal sustainability. Further, the EU must continue with the process of reforms within the banking sector.[43] Under current economic conditions, there remain a large number of challenges for the ECB's monetary policy. The risks associated with the maintenance of price stability over long-term and medium ranges are numerous while sustainability of overall economic stability is a very challenging task.

Despite their potentially temporary character these newly introduced non-standard measures, policies and institutions point towards a centralisation of national sovereign powers in the hands of the ECB. The path chosen by the ECB may prove effective in the long term but is legally uncertain. Non-standard measures may affect the pan-European balance by creating a wholly different political and economic environment than envisaged in the Treaties. Also, it is not unimaginable that various national legal orders may be required to proceed to constitutional amendments in order to bring their legal systems in line with the Bank's requirements.

Given the ECB's deep intervention in national legal, social and financial orders the Bank must reconsider its nature as a purely 'technical' (as opposed to political) institution. In turn, it must assume its responsibilities with respect to accountability demands of the European people. Second, an alternative path is required to remedy both legitimacy and effectiveness issues. Many have placed their hopes on the prospect of a Banking Union. However, this is not free from legal and practical difficulties. The next two sections consider this newly proposed initiative.

5. Banking Union: The Proposal

In 2012, former President of the Commission Barroso, proposed the establishment of a Banking Union on the basis of Article 127(6) of the Treaty. According to Barroso's proposal the principal organ of this institution would be a Single Supervisory Mechanism (SSM) charged with the task to supervise regional banks and to ensure the uniform application of rules. The

SSM would also have supervising authority over banking markets with cross-border elements.[44] The proposal, which has now been approved by the Council, has not foreclosed the ability of non-Eurozone members to participate in the Union. The proposal arguably confers upon the ECB wide powers of supervision and control over regional banks in a somewhat careless manner.[45]

It has become apparent that the ECB is confronted with the difficult task of striking a balance between effectiveness in tackling the financial crisis and preserving the legality of its practices. Arguably, the initiative for a Banking Union can be examined within the context of the tension between legitimacy and effectiveness. While a Banking Union is a step towards resolving important issues of the financial crisis and restoring confidence, it is also an initiative which broadens significantly the mandate of the Bank. Thus, the problem for the ECB and EU is ultimately one of preserving the right balance between dealing with the crisis and staying within the limits of its mandate as prescribed by the Treaties.

5.1. The question of effectiveness

The ECB's response to the crisis has not been completely inadequate. It has managed to lower deposit facility, marginal lending facility, and the main interest rates on key refinancing procedures. Such low rates of interest have supported the banks in bettering their assets, by either procuring liquidity straight from the ECB under the marginal lending facility or by setting up acceptable collateral in return for a loan under main refinancing operations.

Also, the interest rate for deposit facilities has been set at 0%, thus deleting any interest determinant for the central banks to keep their deposit fixed at the ECB. A European Financial Stability Facility (EFSF) in the framework of which the ECB is an important actor was also established by the EU. This body was established to deal with bailouts of nations having sovereign debt at a default level.

Furthermore, the ECB also emphasises on offsetting funding restraints and sustaining liquid markets. Banks possessing enough collateral have been offered unrestrained liquidity and the ECB has enlarged the scope of what constitutes a collateral thus paving the way for assistance by a greater number of banks.

Long term refinancing operations (LTRO) have also been used by the ECB to offer medium-term funds to banks to improve their asset positions. Banks can receive unlimited loan amounts unconditionally and at only 1% interest and use liquidity in any way they desire. The LTRO has been implemented by the ECB in order to thwart a potential credit crisis that might aggravate economic meltdown in the Eurozone.

Aside from LTRO, another important non-standard procedure adopted was the implementation of the Securities Market Program (SMP). The ECB regulates the cash inflow by using different refinancing schemes and the bonds used are either short term contracts for rebuying or collateralised loans. Initially, the SMP was used to buy public bonds from the nations facing economic crisis thus taking over any risks associated with their failing economy. This form of risk assumption was aimed at maintaining liquidity in the market by alleviating speculation and by aiding the central banks of the Eurozone members which faced sovereign debt problems.

Finally, the Outright Monetary Transactions (OMTs) has been created to give effect to purchases of bonds from Eurozone members. OMTs will eventually phase out the SMP. While the OMTs programme is similar to the SMP there is one major difference. Unlike the SMP, the OMT does not lapse and lacks any size restraints. The OMTs programme also offers a wide scope for government involvement. This has created expectations that the programme will lead to an artificially created supplication for the bonds and to a concomitant rise in bond prices and eventually to a release from sovereign debts.

5.2. The question of legitimacy

Considering the initial and main objective of the ECB which is the maintenance of price stability it is questionable whether the ECB is acting within the mandate prescribed by articles 123-125 and 127-130 TFEU. The question becomes more pertinent when considering the creation of the Banking Union and of the SSM.

6. The indispensability and challenges of the European Banking Union

6.1. Introduction

The bailing out of large European banks during an economic crisis may create financial issues for the state which was evident in the cases of Spain and Iceland. Size thus seems to be a first ground for the creation of a banking union. Along with the aspect of size that favours the creation of a banking union the nature of their cross-border enterprises also tends to favour the formation of a banking Union. Some of the European banks control nearly a thousand supplementary bodies that are functioning in different parts of the world.[46] The aims and objectives of domestic banking authorities were not directly concerned with preserving the stability of the Eurozone. Rather, they were mainly focused on sustaining the domestic banking sector. As a result, cooperation between the authorities remained limited during the crisis. A banking union involving bank supervision and resolution and which would also set up general benchmarks for deposit guarantees should thus be established with a view to resolving these issues.

6.2. The nature and characteristics of a European Banking Union

6.2.1. The Banking Union from a political perspective

The Treaty of Maastricht was the commencement of a politically and socially homogenous EU.[47] The creation of an EMU can certainly be conceived as part of this larger endeavour. It was argued earlier that a monetary union is bound to fail in the absence of political integration.

But this observation can also be reversed. Indeed, a socio-politically integrated whole is not easily imaginable in the absence of a monetary union.

It is within this context that one needs to approach the prospects of a Banking Union. A Banking Union can be seen as the equivalent of the Monetary Union within the European banking sector. That is, apart from its strictly technical characteristics a Banking Union also serves as a further step towards the kind of political integration (and perhaps also solidarity[48]) that Europe has been struggling to achieve for more than two decades.[49]

6.2.2. The Banking Union from a technical perspective

A single banking supervisory system should create both a single procedure for providing help to the banks facing bankruptcy and a procedure for deposit guarantee. Still, the Banking Union is sometimes described as 'a term of art' lacking any distinct meaning.[50] For all the unpredictability that naturally surrounds a project that has not yet been completed there are at least three ways in which the Banking Union will function.

First, a Banking Union will signify the homogenisation of regulation and supervision of the European banking sector at least as far as the major domestic banks are concerned. The authority charged with supervision will be the ECB. A Banking Union will bring about uniformity in the resolution process for banks going bankrupt. A common process of exchange of several forms of aid between institutions will thus be established.[51] Finally, a common guarantee fund will be necessary for the completion of a Banking Union. Common guarantee funds are currently a purely domestic matter which will need to cross domestic borders and be re-established at the regional level if a Banking Union is ever to materialise.[52]

The ECB at the helm of the banking union will be in charge of the financial institutions of the Member States. It will have the power to approbate all Eurozone credit institutions and will be

in charge of the rightful implementation of the Single Rulebook.[53] There will be a uniform standard for liquidity, level of leverage, and funding. Further, the ECB may proceed to corrective actions or capital buffer where necessary and in agreement with state governments.[54] Aside from being the lender of last resort, it will be in charge of supervising all banks that will form part of the union (i); it will directly govern banks with assets exceeding 30 billion euros or 20% of the national GDP (ii); and, finally it will govern banks that receive aid from the ESM (iii).[55]

The next section considers the difficulties facing the Banking given that the legal framework for handling bank debts has traditionally been a matter of domestic jurisdiction.

6.3. The barriers in the creation of a banking union

6.3.1 Three plus one difficulties inherent in the creation of a Banking Union

6.3.1.1. Risks, administrative arbitrage and competitive representation

The establishment of a Banking Union is not an easy task. The first issue to be tackled relates to the moderation of the risks which are common between the states and banks so that sovereign debt and banking crises will not be able to jointly reinforce each other. The second issue pertains to the possibility of administrative arbitrage involved in the transfer of the banking regulation and supervision to the Eurozone level. A third issue is related to the need to decrease competitive misrepresentations.

6.3.1.2. The problem of forum-shopping

The most significant difficulty stems from the fact that Eurozone banks operate overseas while remaining closely interlinked to their states. This disparity has not merely created a vicious circle of sovereign debt and banking crises. It also constitutes a major obstacle with respect to

the creation of a Banking Union because domestic authorities habitually focus on maintaining the stability of the banking sector at the national level instead of working towards creating a stable banking sector throughout the entire Eurozone.

This is not inexplicable considering that banking crises are often avoided through the utilisation of domestic public finances. As a result, large-scale debts increase the vulnerability of banks to break down in times of crises as they are left with inadequate capital to make up for the losses. Large amounts of sovereign debt would also destabilise the national banking sector because the latter is in charge of vast amounts of public debt which does not require reinforcement with capital. If there are losses pertaining to the value of government bonds banks will face net losses which can potentially lead to a need for bailout by the government.

To summarise, countries have an incentive to attract businesses by having less stringent standards. This does not merely constitute an obstacle for the creation of a Banking Union but also offers a further reason why such a Union is indispensable. The establishment of higher standards requires cooperation between the national banks as well as the prioritisation of the stability of the entire Eurozone over national economic stability.

6.3.2. The current developments in the EU-The discontents of the Banking Union

Currently, one of the largest projects is the Banking Union reform despite concerns voiced by experts and academics.[56] There are three pillars to the Banking Union which have been delayed due to a lack of consensus. The first pillar is comprised of the banking supervision, the second concerns a bank settlement the third is concerned with a resolution fund. There are two areas of dispute

First, there is dispute regarding controlling power between European institutions and member states. While the EC has proposed the transfer of supervisory authority to the ECB the Eurozone governments prefer supervision to be restricted to the major banks in order to leave

scope for domestic regulators to continue playing a significant role within the banking sector. This is translated into an effort of the Eurozone members to transfer as little sovereign powers as possible to the supranational institutions of the Union.

Second, there is debate between debtor and creditor nations. The economically stronger have attempted to delay the formation of the Union while the indebted nations are in need of a fast start-up. For example, Germany agreed to the proposed plan only in mid-2012 but has repeatedly delayed the procedure by asking for thoroughness over the entire proceeding. The government feels that the European and the German taxpayers will end up paying for the debts of the weak banks while debt-ridden nations will be exempted from carrying the burden.

A relevant subject of controversy is the ‘liability cascade’ proposed by Schäuble. The scheme involves savers and shareholders being the first to assume liability for the debt, while taxpayers would be held liable only at a later stage. However, analysis shows that under the liability cascade the taxpayers do not get any real safety as the cash amount in the fund settlement remains little.

At the same time, Europe has garnered more than 1 trillion euros for its bank bailout. Ireland received 90 billion euros as bailout loans for its banks. Owing to similar instances, there were more demands for creating a Banking Union that would help to break out of the vicious circle of sovereign debt and banking crisis. The following section explores the mechanisms through which a Banking Union will seek to bring about an effective resolution through the SRM and deposit guarantee scheme.

6.4. The SRM and the deposit guarantee scheme

The creation of a pan-European single resolution mechanism (SRM) was initially proposed in 2012. The SRM places power in the hands of the European banking authorities to intervene during recovery plans and even to remove bank managers in case capital requirement is not met. It also makes provisions for national authorities to assume control. This measure will give

authorities power to record claims from unsecured creditors of a bankrupt financial institution and to transfer debt to equity. SRM also necessitates the creation of resolution funds that would give a short-term protection to institutions under resolution. In addition, the Member States must guarantee that their institutions keep an adequate amount of funds so as to be able to cushion some of the losses during a crisis.[57]

The banking union must also focus on creating a deposit guarantee scheme that safeguards savers when a bank faces bankruptcy.[58] During a crisis, a lack of transparency may spread panic and cause depositors to withdraw large amounts of their money. This may lead to a solvency crisis and have adverse effects on the overall economy. The deposit guarantee scheme works towards avoiding such situations. The EC proposed a deposit guarantee system applicable on the entire region. It comprises the creation of a system that allows for mutual borrowing from all available funds.[59] However, the scheme created a conflict between the Council and the European Parliament with Member State officials supporting a cut in financing rates of the banks and EP members being in favour of an increase in funds coming from risky banks through risk premium. Given this inter-institutional controversy the proposal is yet to be passed.

6.5. The SSM and the quest for independence

The creation of the SSM served as the preliminary step which would prepare the ground for the Banking Union. The importance of the SSM became evident in 2012 as it enabled direct intervention of the ESM in the banking sector thus marking a significant increase in the effectiveness of management with respect to the banking aspects of the crisis.[60]

The principal objective of the SSM is the establishment of a single banking supervisor for the entire Eurozone and the creation of a separate institution that will have full authority over all the European banks.[61] It is suggested that a separate supranational body handling banking

supervision can minimise political influence and speed up the achievement of banking goals while enhancing the credibility of banking decisions.[62]

Independence would allow the supervising authority to guarantee credibility and ensure that not all banks would be bailed out. This would motivate banks to decrease their risk-taking ventures. An independent ECB would also guarantee the faster implementation of bankruptcy procedures while it would foreclose the possibility for harmful delays. An independent supervisory board would place distressed banks under surveillance prior to them going bankrupt. This would prevent them from turning into a threat for the entire economic sector of the region. An independent single supervisory board would keep speculation under control. The SSM will guarantee the authority to control the monitoring of smaller banks by the national supervisory authorities which in turn will be answerable to the ECB. The main benefit being that the ECB will receive all data from the national supervisory authorities while the SSM will receive expert guidance from the national supervisory authorities.

However, the SSM regime will face various problems as at present the European banking sector is highly diversified and GDP to balance-sheet ratios vary greatly among the different Member States. The main disadvantage is that the banking union will result in inconsistencies between the ECB policies and the national strategies on economic and banking issues because some nations will prefer to remain in charge of their banking system.

6.6. The indispensability of the Banking Union

6.6.1. The sovereign debt and banking crisis

Seen in purely economic terms the crisis is primarily a sovereign debt crisis. It is submitted, that the severe sovereign debt crisis of Eurozone members cannot be understood separately from the crisis of the banking sector. It has long become more than obvious that the current state of economic and financial affairs in not sustainable. In particular, before the onset of the

crisis, European banks had taken part in the creation of the real estate and financial bubbles. Once the bubble broke the governments had to arrange for bank bailouts, which proved costly for states like the UK, Ireland, Spain and Germany. At the same time, the sovereign debt crisis led to an increase in the difficulties faced by the banks while public debts turned into risky assets.

As already stated, part of the problem was that small nations such as Cyprus and Ireland could establish banking systems that were too big for them to effectively handle. As a result, the state governments were unable to salvage them during the debt crisis.[63] In 2012, the overall stability and effectiveness of the European banks has been called into question as the measures adopted from 2008 proved inadequate. Spanish banks were on the verge of complete breakdown having increased their debts from nearly 3% in 2008 to more than 10 % in 2012.[64] As a result, bank deposits decreased in Ireland, Greece, and Spain, among many other states.

The proposal for a banking union came partly to respond to the urgent need to disentangle the sovereign debt crisis from the banking crisis. Proponents of the idea suggested that a banking union would 'break the link between sovereign debt and bank debt and the vicious circle which has led to over €4.5 trillion (or 37% of EU GDP) of taxpayers' money being used to rescue banks in the EU.'[65] But the reasons in favour of a Banking Union go further than this. They will be examined in the following section.

6.6.2. The necessity of a Banking Union

The reasons offered by academics and political actors in favour of a banking union are numerous. They range from self-evident observations such as the need to save the Euro to less obvious ones such as the need to move to a complete reintegration of the European banking system.[66]

Perhaps the most important reason in favour of a Banking Union is the need to disentangle national banks from the national bias of their respective domestic administrations. The fragmentation of the European capital market along national lines, so the argument goes, does not only impede Europe's ability to overcome the crisis; it also constitutes a continuous threat against the banking sector.[67] Additionally, a Banking Union is also bound to create incentives for proper regulation and supervision at a national level.[68] While the core of the Banking Union will enable the ECB to supervise only the large banks, it will also bestow on it the right to 'watch' smaller banks.[69]

It becomes obvious that the Banking Union will be a significant step towards resolving the crisis issues. It is perhaps the most robust and effective measure that is to be taken to this effect. But, how does the legitimacy-effectiveness balance translate in the case of the Banking Union?

7. Issues of legitimacy and Accountability

The issues of legitimacy and accountability of the ECB were highlighted by Leino.[70] Legitimacy of the ECB refers to the belief that it is recognised as being the appropriate institution to exercise powers. Accountability refers to the responsiveness of the institution to the people affected by its decisions.[71] The two issues are linked where there is a discrepancy between the ECB's political independence and the demands for greater legitimacy through the implementation of stricter standards to guarantee accountability.[72] Therefore, while a Banking Union may be perfectly legitimate on the basis of the political independence of the ECB (the body that creates it), this may on balance be a step too far because of a lack of accountability due to poor responsiveness which undermines legitimacy.

Let us note at the outset that article 127(6) of the Treaty has been deliberately formulated in broad and open-ended terms. It leaves open the possibility to grant to the ECB the authority to supervise the entire European banking sector.[73] Thus, on first reading and from a strictly legal

perspective a Banking Union does not appear to be problematic in terms of democratic legitimacy.

However, things are not as straightforward as may appear. First, the Eurozone being a group of states with different historical, socio-economic, tax and legal systems is comprised of a number of divergent banking systems. Therefore, it is not surprising that the EP and Council could not reach consensus around the SRM. The SRM may necessitate broad Treaty amendments and in this respect it is not accurate to claim that the Treaty unconditionally allows for the creation of a Banking Union. It is for this reason that the common deposit insurance scheme in constantly postponed.[74] The crux of the problem seems to be that certain governments will have to carry the burden of last resort payment when banks fail.

Such schemes should also require fiscal support. A banking union cannot be understood separately from a political union and to a certain extent also from a fiscal union. Such a development would be extremely far-reaching necessitating the transfer of a great deal of domestic responsibilities to the supranational European authorities. This constitutes an important legitimacy issue in and of itself. The problem boils down to the size of the ECB's mandate. For example, is the ECB an authority bestowed with enough political legitimacy to proceed to bank resolution activities which will require important decisions on redistribution? Or should an additional independent authority be established to this end? The second scenario may necessitate a Treaty revision in order to confer on the new independent body the legal basis and political legitimacy needed in order to perform such major political task.

In fact, the ECB being an organ consisting of a group of unelected officials lacks the political and democratic legitimacy to make such decisions. The ECB's legitimacy derives precisely from the fact that its mandate is limited. Further, it is submitted that it should remain so. The Bank's authority has already been questioned by the German Constitutional Court in the case of

the OMTs. The ECB should preserve its legitimacy and public confidence in it by holding back from any activity that would once again put the lawfulness of its actions into question.[75]

It is evident that if Member States reach consensus on the deposit scheme the EU, they will need to be cautious around issues of legitimacy, transparency and accountability in decision-making processes especially given that the relevant decisions will affect redistributive policies in the whole region.[76] Greater legitimacy may be achieved through better democratic accountability of the ECB.[77] However, as noted earlier, it is accepted that the ECB lacks democratic accountability. Therefore, different supervisory and accountability mechanisms are required.[78] Unfortunately, such mechanisms are unlikely to enhance legitimacy in practice.[79] As such, problems of legitimacy will remain. It has been noted that, '[we] have to look… not only at the area that acquires jurisdiction and power, but also to the State, which loses it and becomes less and less able to respond to citizens' expectations and the challenges of present-day economic stabilization'.[80] This is a major problem of modern constitutional systems which is not limited to the banking sector. It concerns the increasing transfer of sovereignty to supranational /transnational authorities. The relevant discussion is beyond the scope of this essay. It is however relevant to our topic as it may throw off balance any attempt to transfer to the supranational level the authority to make decisions that have traditionally been the prerogative of domestic authorities.[81]

The creation of the Banking Union must be accompanied by regulations that seek to avoid repetition of such debt crises while preserving the overall legitimacy and accountability of the system. Some suggest that a supervisory organ be created to control the acts of the ECB.[82] This argument becomes more powerful considering the extension of power implications brought about by the creation of a Banking Union. However, problems of implementation remain,

particularly because certain respects a universal bank model still remains constitutionally vague and brittle.

8. Conclusion

The changes in the policies of the EU after the Eurozone sovereign debt crisis broke out have been a decisive moment in the process of European integration. The crisis has brought to light the weaknesses of an institutional regime that was designed to protect the stability of the European financial market and ensure the welfare of European citizens. The response to the debt crisis necessitated major changes in the European financial market while it highlighted the need to enhance regional and global coordination on economic, monetary and fiscal policies. The formation of an integrated European financial market and the establishment of the EMU among 17 Member States created shortcomings that became evident already at the initial stages of the debt crisis in 2008.[83] Despite the efforts undertaken with a view to completing the EMU and the Eurozone single financial market financial security was weak and lacked the appropriate balance.

The European crisis revealed the loopholes associated with the process of integration and gave rise to new proposals and initiatives for a more effective integration. First, the credibility and strength of domestic policies cannot be used as a stand-in for cross-border commitments. Second, instead of framing stringent standards and landmarks to meet the demands of individual states effective integration should promote the development the regional economy as a whole. This will in turn bring about growth and stability while alleviating contagion risks.

The EU had to make a number of difficult choices that involved the need to strike an appropriate balance between collective economic stability and state sovereignty. It will need to move ahead with precaution as these areas still remain largely unexplored. Furthermore, the

ECB lacks a strong 'treaty-based' authorisation that would work as a shock-absorber during sovereign debt crises. This absence constitutes an important gap within the reform process.[84]

However, for all the problems the establishment of a Banking Union is a move in the right direction as it will foster the much-desired political (and fiscal) integration of the European Monetary Union. It is submitted that the process should be dynamic and evolve gradually. Taking into consideration the regulatory issues as well as the various complaints.

Furthermore, the issue of legitimacy points to very relevant concerns about the limits of ECB power in the creation of a Banking Union. One solution is to have external oversight of the ECB on this matter. Another solution is to enhance the democratic accountability. However, the matter remains unresolved, meaning that the common Resolution Fund must be used with caution.

The continuous absence of capital requirements necessary for government bonds must be resolved as banks must possess adequate capital before the Banking Union is established. The cleaning up of balance sheets is also a herculean task that must be handled by the ECB. In light of this, it is essential that the SRM's resolution scheme starts operating as soon as possible.

A new independent authority should be established which should be made answerable to the democratically elected European Parliament. Finally, it is not surprising that the Banking Union has not as yet materialised. For all the hopes that the project will eventually resolve some of the weaknesses which led to the banking and sovereign debt crises its establishment constitutes an unprecedented and critical point in European history. It is a major step towards political integration while it necessitates the transfer of a great amount of sovereign matters to the European level. The EU is now at a historical crossroads. It must find the most effective, accountable and legitimate way to persuade governments that the Banking Union is an

important step towards the resolution of the crisis and the achievement of solidarity within the Eurozone and the greater region.

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