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The European Banking Union in a Global Context

European banking union has been hailed as the most important step of EU integration since the formation of European Economic and Monetary Union. It forms part of the post-crisis trend towards (i) international re-regulation of the financial system, (ii) closer international supervisory cooperation, in order to better cope with systemically relevant, globally active financial firms, (iii) an institutional overhaul of financial supervision worldwide, and (iv) the European Union's crisis-triggered strengthening of economic and financial governance.

As other types of integration, its economic effects cannot be expected to be limited to the countries forming part of the integration area; substantial "side effects" may be expected for the rest of the world.

At a first level, the question arises whether effects akin to trade creation versus trade diversion might happen. In other words, to what extent will the stabilisation and strengthening of the euro area economy resulting from the banking union create positive effects for financial firms outside the banking union; and to what extent might the expected continuation of a deepening of financial integration among participating countries „deflect" business to financial firms from within the banking union.

Which circle of countries should form a banking union? For the European banking union, this question was decided pragmatically in the sense that euro area countries will take part, non-euro area EU Member States may opt in, while other countries are excluded. This solution seems to make sense in many respects. The euro area indeed implies and requires deep financial integration and the formation of the banking union was a strong signal of political will towards deeper integration. But the decision was not primarily based on economic grounds, let alone on an economic theory.

Does the European banking union constitute an „optimal banking union" or "optimal regulatory and supervisory area"? While for currency unions there is a widely known theory and large literature on "optimal currency areas", hardly any research exists on banking or regulatory unions. Dell'Ariccia explains in this volume a theoretical framework to evaluate this question, based on regulators' incentives, including regulatory capture, and on externalities from regulation. He concludes that the benefit from regulation is the internalisation of externalities which characterize regimes with nationally separate regulators. By contrast, the costs of centralized, "one size fits all"

regulation become bigger for countries whose banking, financial markets and real economy structures differ substantially. Thus, countries with higher financial integration and similar regulatory needs are likely to benefit more from a banking union. This result would advise to base a decision on banking union membership on financial integration and structure. This analysis neglects, however, aspects of crisis management, the breaking of sovereign-bank vicious circles, problems of suboptimal ring-fencing and lack of cross-border coordination in banking resolution – all these problems can be tackled by a banking union.

What are the economic consequences for ”outsiders“ of the European banking union? As Benediktsdóttir in this volume points out, there are different degrees of „outside-ness“: non-euro area EU Member States (who may opt into the banking union), European Economic Area (EEA) countries (bound by the single rulebook but having no option to become part of the banking union), and the non-EU/EEA rest of the world. Particularly, internationally active banks covered by the European banking union may expect to reap a number of benefits: reduced compliance costs due to a single supervisor, a “seal of approval“ by a strict, credible central supervisor, and resulting better ratings and lower refinancing costs. This may also create pressure for regulators outside the banking union to regard rules and procedures in the banking union as a “benchmark“ for their own rules and practices.

Furthermore, the banking union dramatically increases the size of the “backing“ supervisor, central bank and fiscal authority, creating a much more generous reference point to judge when a bank becomes „too big to fail“. All these aspects may potentially put banks operating from outside the banking union at a competitive disadvantage. Furthermore, during times of crisis, the stability generated by the banking union may result in the euro area becoming a safe haven, with several more or less welcome implications (interest rates, exchange rate, credit etc.).

The banking union may also increase the international perception of the euro area as one single entity, potentially strengthening its clout in international negotiations on regulatory, supervisory and monetary matters.

But there are also arguments that argue against non-euro area EU Member States opting into the banking union. The positive externality, in terms of higher stability for the global financial system generated by the banking union, may reduce the incentive for further countries to join, because this benefit is reaped also without their participation. At the same time, the costs of less „elasticity“ to accommodate national institutional and structural specificities and of less „regulatory and supervisory lenience“ to support the profitability and global competitive position of domestic banks or an entire financial centre can be avoided by staying outside the European banking union. Finally, for countries (such as the U.K.) whose banks have their main links with other parts of the world outside the banking union, it may indeed be economically more optimal not to join.

All these issues are elaborated in more detail in the following two contributions in this volume by Dell'Ariccia and Benediktsdóttir. Similarly to EMU, also European banking union is a bold historical experiment. Experience with its practical implementation will likely evolve over time, and so will its implications for, and the resulting reactions by financial firms, regulators and supervisors, in the rest of the world.