EU Proposes 'Banking Union'

By GABRIELE STEINHAUSER

BRUSSELS—The 17 countries that use the euro should consider setting up a "banking union" that allows them to share the burden of bank failures, the European Union's executive arm said Wednesday in a report on the currency union's crisis-fighting efforts.

To further stop expensive bank bailouts from pulling down governments' own finances, allowing the euro zone's new rescue fund to directly boost the capital of banks "might be envisaged," the European Commission said.

At the moment, any financial aid to prop up struggling banks would have to be requested by the firms' own government, pushing up its debt and deficit burden. The fear is that even if the government gets the required bank aid from the bailout fund, it would damage its efforts to raise money from the bond markets to finance the rest of its operations.

The Commission's suggestion for a banking union comes as vulnerable euro countries like Italy and Spain have seen borrowing costs jump in recent weeks while the euro's value has slumped. Spain's troubles, in particular, have been compounded by the weakness of banks suffering the effects of a property-market meltdown.

Investors have also shied away from the currency union's weaker members amid concerns that Greece may have to leave the euro and spark further turmoil in the bloc's financial sector.

The Commission publishes on Wednesday specific recommendations for all 27 EU countries as well as the euro zone as a whole. Many economists have called on the Commission to give countries more time to cut their budget deficits to avoid pushing them further into recession.

In its own staff report, which was released ahead of the recommendations, the Commission paints a dark picture of the euro zone's economy—even in relatively strong countries.

"Even member states that had been regarded as financially sound became affected and the crisis became systemwide in the second half of 2011," it said. "This reveals the strength of spillovers in the euro area...and is a call against complacency for those seemingly unaffected."

At their weekly meeting Wednesday, the 26 European commissioners and their president were discussing whether to relax budget targets for some countries now that their economies are much weaker than when the targets were first drawn up.

Here, the Commission—and Europe as a whole—finds itself in a...
On the one hand, the governments need to show investors that they will get their high debts under control. On the other hand, cutting spending in the middle of a recession will increase economic hardship and unemployment and ultimately push up the debt burden relative to the size of a country's economy.

"Member States which face high and potentially rising risk premia do not have much room for maneuver to deviate from their nominal fiscal targets, even if macroeconomic conditions turn out worse than expected," the Commission said.

However, it called on countries that face less market pressure to let their automatic stabilizers work—economic jargon for not making up for lower-than-expected growth by cutting unemployment and other benefits.

Although the Commission has presented its annual country-specific recommendations as a major element of its crisis response, whether it actually changes the budget targets for some governments may ultimately not matter so much.

For instance, Commissioners were debating Wednesday afternoon whether to give Spain until 2014 to its deficit to 3% of gross domestic product from 8.5% in 2011. But already in its own working paper, the EU’s executive made it clear that reaching the target will be very difficult.

Spain’s own growth expectations are more optimistic than the EU forecasts, the Commission said, adding that the country’s relatively independent regions are also set to miss their budget targets and thereby weigh on the overall deficit.

On top of that, spending on unemployment and other benefits may be higher than Madrid currently predicts, while further bank rescues may also become expensive, the Commission warned.

And even if the Commission decides to loosen the budget targets for stronger countries like Germany and the Netherlands—in the hope that that would stimulate growth across the continent—it is far from clear that their governments would take advantage of the extra space.

Germany already cut its deficit below the EU’s 3% limit two years ahead of time and has rejected calls to slow down fiscal consolidation. The Netherlands, meanwhile, passed further budget cuts for this year even after its coalition government collapsed.

Those issues underline that it will most likely require structural changes to the way the currency union works to pull the euro zone out of crisis. On top of suggesting ways to share the burden of bank bailouts, the Commission said it would soon make specific proposals for so-called euro bonds, debt backed by all 17 euro countries.

**SmartMoney Glossary:**  euro, deficit, expensive, governments