ARCHIVIO ISTITUZIONALE
DELLA RICERCA

Alma Mater Studiorum Università di Bologna
Archivio istituzionale della ricerca

One money, two markets? EMU at twenty and European financial market integration

This is the final peer-reviewed author's accepted manuscript (postprint) of the following publication:

Published Version:
Howarth D., Quaglia L. (2020). One money, two markets? EMU at twenty and European financial market integration. REVUE D'INTÉGRATION EUROPÉENNE = JOURNAL OF EUROPEAN INTEGRATION, 42(3), 433-448 [10.1080/07036337.2020.1730346].

Availability:
This version is available at: https://hdl.handle.net/11585/763371 since: 2020-06-28

Published:
DOI: http://doi.org/10.1080/07036337.2020.1730346

Terms of use:

Some rights reserved. The terms and conditions for the reuse of this version of the manuscript are specified in the publishing policy. For all terms of use and more information see the publisher's website.

This item was downloaded from IRIS Università di Bologna (https://cris.unibo.it/).
When citing, please refer to the published version.

(Article begins on next page)

27 September 2024

This is the final peer-reviewed accepted manuscript of:

David Howarth, Lucia Quaglia (2020): One money, two markets? EMU at twenty and European financial market integration, *Journal of European Integration*, 42 (3): 433-448

The final published version is available online at:

https://doi.org/10.1080/07036337.2020.1730346

Terms of use:

Some rights reserved. The terms and conditions for the reuse of this version of the manuscript are specified in the publishing policy. For all terms of use and more information see the publisher's website.

This item was downloaded from IRIS Università di Bologna (https://cris.unibo.it)

When citing, please refer to the publisher version.

One Money, Two Markets?

EMU at Twenty and European financial market integration

David Howarth, University of Luxembourg
david.howarth@uni.lu

Lucia Quaglia, University of Bologna
lucia.quaglia@unibo.it

Not for citation without permission of the authors.

Currently under review at the *Journal of European Integration*.

Abstract

This contribution combines neo-functionalism and historical institutionalism to understand the implications of differentiated integration in Economic and Monetary Union (EMU) and Banking Union (BU) for the single market in financial services in the European Union (EU). From the 1980s, the relaunch of the Single Market and monetary integration in the EU were presented by the supporters of EMU as mutually reinforcing, as in the logic of the Commission's Report 'One Market, One Money'. Initially, EMU appeared to reinforce financial integration, especially in the Euro Area banking sector, even though EMU was a case of differentiated integration in the EU. Subsequently, the incomplete EMU triggered the sovereign debt crisis, which undermined financial market integration and was addressed through the establishment of BU, which reinforced differentiated integration. Both EMU and BU have negative implications for the 'singleness' of the single market in financial services, potentially resulting in 'One Money, Two Markets'.

Keywords: Economic and Monetary Union, Single Market, Banking Union, financial regulation, banking supervision, European Central Bank, Single Supervisory Mechanism

Introduction

The single market in financial services is a crucial part of the European Union (EU) single market given the importance of finance to economic growth and the implications that finance has for other EU policies, and notably macroeconomic policies. As early as 1990, the European Commission published an influential report entitled 'One Market, One Money' (Commission 1990), which was strategically used to promote Economic and Monetary Union (EMU). The report was focused in large part upon the galvanising effect that the single currency would have for market — and notably financial market — integration (Emerson et al. 1992; cf. Gros 2017). Over two decades later, the 'completion' of EMU through Banking Union (BU), which was put forward by the so-called Four Presidents Report (Van Rompuy 2012) and was elaborated further by the so-called Five Presidents Report (Juncker 2015), re-stated the linkage between the Single Market and the Single Currency. The Four Presidents Report (Van Rompuy 2012) that outlined the BU project listed the 'single rulebook' (that is to say, EU banking regulation) as a core component of Banking Union, even though BU involved only Euro Area member states and other EU member states that were willing and able to join, although none has yet done so.

This contribution examines the interactive dynamics between the Single Currency and the Single Market in financial services, with a particular focus on developments in the second decade of EMU and, specifically, since the start of the sovereign debt crisis in the Euro Area. Despite notable exceptions (e.g. Dyson and Marcussen 2010; Jones, Kelemen and Meunier. 2015; Schimmelfennig 2016, Vilpi auskas 2013) most of the political science literature has so far focused on either EMU or EU financial services governance. By contrast, this contribution considers how and why these two policy areas have mutually affected each

other, and with what outcomes.[1] Building on Schimmelfennig (2016), we offer novel insights by combining two major theories, one drawn from European integration studies — neo-functionalism — and one from political science — historical institutionalism to assess the implications of the differentiated integration created by EMU and BU, for the Single Market in financial services.

This contribution is organised as follows. Section 2 presents our analytical framework and summarises the potential usefulness of neo-functionalism and historical institutionalism to explain the impact of the differentiated integration created by EMU on financial market integration. Section 3 examines the first decade of EMU and the re-launch of financial market integration through the European Commission's Financial Services Action Plan, up to the international financial crisis and the outbreak of the Euro Area sovereign debt crisis. Section 4 examines the regulatory response of the EU to the international financial crisis, and subsequently the EU's main institutional and policy response to the sovereign debt crisis that was BU, and the proclaimed 'completion' of EMU. Finally, the contribution reflects on the implications of BU for the Single Market in financial services.

Theorising the relationship between monetary integration and (financial) market integration

The analysis of this contribution is informed by two theoretical approaches, one drawn from European integration theory — neo-functionalism — and one drawn from political science — historical institutionalism. These explanations are combined to draw insights to better

[1] The political science literature on EMU is vast: we note only some of the major studies, inter alia, Chang 2009; Dyson and Featherstone 1999; Dyson 2000; Hodson 2011; and Verdun 2002. On EU financial market integration, see Donnelly 2010; Macartney 2010; Mügge 2010; and Quaglia 2010.

understand the dynamics and implications of differentiated integration in the EU. Both neo-functionalism and historical institutionalism have been applied to explain European market integration (Armstrong and Bulmer 1998; Pierson 1996) and EMU developments and, most recently, the Euro Area crisis (Niemann and Ioannou 2015; Schimmelfennig 2014a; Schimmelfennig 2014b; Verdun 2015; Vilpi auskas 2013), the move to BU and the differentiated participation of EU member states therein (Kudrna 2016; Dyson and Marcussen 2010; Schimmelfennig 2016).

Neo-functionalism considers three different types of ‘spillovers’ (Haas 1958; Niemann and Ioannou 2015; Schmitter 1970; Vilpi auskas 2013). ‘Functional spillovers’ are driven by economic dynamics in the policy field and result from previous but incomplete integration. Thus, the principal functional logic for adopting a single currency stemmed from the Mundell-Fleming ‘unholy trinity’ or ‘monetary trilemma’, whereby the preference for fixed exchange rates and the liberalisation of capital flows — both designed to bolster market integration in Europe —would prevent most member state governments from pursuing autonomous monetary policy. Tommaso Padoa-Schioppa, then a high-ranking Bank of Italy official — and a future ECB Executive Board member and Italian Minister of Finance — made an addition to the monetary trilemma with the explicit aim of linking the need for a single currency with the European Community (EC) internal market, thus proposing the ‘inconsistent quartet’ (Padoa-Schioppa 1982). The addition of ‘free trade’ to the monetary trilemma was logically problematic and unnecessary — capital liberalisation was an important element of European market integration. However, it was useful for those seeking to promote EMU — creating a stronger theoretical foundation to the spillover relationship between market integration and the Single Currency.

‘Political spillovers’ derive from the preferences of business interest groups and civil society in favour of policy supranationalisation. In particular, transnational economic interest groups and companies engaged in cross-border business tend to support further integration that facilitates gains from economies of scale, for example, by reducing the costs of having to comply with a variety of different national regulation (Sandholtz and Zysman 1989). This was notably the case in the relaunch of the single market in financial services, which was strongly supported by the most competitive parts of the financial industry that sought cross border opportunities to expand their business (see Macartney 2010; Mügge 2010).

Lastly, ‘cultivated spillovers’ are generated by the preferences and active efforts of supranational actors, such as the European Commission and, more recently, the ECB, to further the integration process (see also Niemann and Ioannou 2015). This aspect is also emphasised by the literature on supranational governance, which builds on neo-functionalism, and several works that consider supranational leadership on both market and monetary integration (Jabko 1999, 2006; Posner 2005) and the strategic efforts to link the two. Throughout the 1980s and 1990s, the European Commission promoted both market integration and monetary integration as mutually reinforcing. Indeed, a solution to the ‘inconsistency’ of the quartet mentioned above could have been to renounce semi-fixed exchange rates. However, the Commission insisted that the gains of the Single Market could not be optimised without a Single Currency: notably in the influential publication ‘One Market, One Money’ (Commission 1990; see also Emerson et al. 1992).

Neo-functionalist spillovers overlap with historical institutionalism’s path dependency. In one of the earliest applications of historical institutionalism to European integration, Pierson (1996) developed a two-step process of endogenous change. First, member states lose control

of the integration process due to, among several factors, the unintended consequences of spillovers resulting from high issue density, the activities of supranational bodies and the creation of new actors. Second, member states can fail to reassert control over the direction of integration because of institutional barriers, including the difficulty of treaty and EU legislative reforms and the endogenous interdependence created by EU-level policy developments, which involve both sunk costs and exit costs, which, in turn, can exceed the benefits that states can gain from leaving or reversing an integrated policy. In such a situation, member state governments might also accept further integration in order to reduce inefficiencies and negative externalities created by the integrated policy area.

The concepts of spillovers and path dependency have been used to explain 'differentiated integration' in the EU, that is to say, 'a situation in which states participate in EU policies at different levels of integration or EU rules are not uniformly valid across states' (Schimmelfennig 2016, see also Schimmelfennig 2014b; Schimmelfennig, Leuffen, and Rittberger 2015; Leruth and Lord 2015).[2] Dyson and Sepos (2010) define differentiated integration as 'the process whereby European states … opt to move at different speeds and/or towards different objectives with regard to common [European] policies. It involves adopting different formal and informal arrangements (hard and soft)'. The focus on differentiated integration to examine the relationship between EMU, BU and financial market integration makes sense because only a subset of EU member states opted to participate in EMU and BU, whereas all member states participated in market integration which remains the 'constitutional core' of European integration (Howarth and Sadeh 2010; see also Dyson and Marcussen 2010). In this context, both neo-functionalism — and its focus on spillover — and historical institutionalism – and its focus on path dependency – would lead us to expect

[2] See Schimmelfennig et al. 2015 for a more detailed discussion of definitions of differentiated integration.

that Euro Area member states would be subject to different spillovers and a distinct path dependency compared to 'euro-outsiders'. Schimmelfennig (2016) demonstrates the importance of path dependency with regard to the move to BU and the non-participation of 'euro-outsiders'. In our contribution — combining neo-functionalism and historical institutionalism in the context of differentiated integration in specific areas — notably, EMU and BU, we hypothesize the following:

EMU and BU both create spillover pressures and path dependency that have worked and will continue to work to undermine the single market.

Alternative explanatory frameworks that might be applied to examine the relationship between EMU and financial market integration include Liberal Intergovernmentalism and versions of Constructivism. Liberal Intergovernmentalism (Moravcsik 1998; Schimmelfennig 2015) would explain developments in terms of the preferences of powerful member state governments which, in turn, reflect the preferences of powerful domestic economic constituencies. A 'battle of systems' (Story and Walters 1997) — in which member state governments defend the interests of differently configured national financial systems — delayed financial market integration and ensured the persistence of major differences among Euro Area member states on financial regulatory developments. Thus, national governments half-heartedly supported financial market integration and this resulted in a limited delegation of powers to the EU level to achieve this — for example, the creation of the EU supervisory authorities with limited policy making powers. Intergovernmentalism has been criticized, inter alia, for considering national preferences as static and mostly exogenous to the integration process (Wincott 1995). Indeed, empirically, there are instances in which national preferences on a given policy or issue have changed over time due to spillover effects

emphasized by neo-functionalist accounts. Notable instances have been member state governments' support for the supranationalisation of banking supervision and resolution in response to the sovereign debt crisis in the Euro Area, as explained below.

An application of Constructivism involves placing emphasis on the intensification of identity construction of the member state actors most involved in EMU (McNamara 1998, Risse et al. 1998) and the spread of specific ideas that, then, reinforced the need for financial market integration. For neo-functionalists too, the focus would be on socialization pressures that stemmed from the operation of EMU and encouraged political and cultivated spillover into additional areas of policy making. However, given that some of the EU member states among the most consistently in favour of further financial market integration and 'market-making' reforms (Quaglia 2010, 2012) remained obstinate euro-outsiders — notably, the United Kingdom, Denmark and Sweden — whereas a number of Euro Area member states remained strongly reticent on financial market integration — notably, Germany — the application of a constructivist framework in this regard appears problematic. While the 'market-shaping' perspective dominated in most Euro Area member states and directed government policy, a number of Euro Area member states — notably, the Netherlands, Ireland and Luxembourg — consistently allied with 'market-making' euro-outsiders on financial regulatory issues.

The first decade of EMU and the 'completion' of the Single Market in financial services

The beginning of the third and final stage of EMU was the starting point of a form of differentiated integration in the EU. It can be seen as constituting a 'critical juncture' placing Euro Area member states and euro-outsiders on different paths of policy and institutional

development.[3] One the one hand, EMU created a series of functional, political and cultivated spillovers. On the other hand, these spillovers were stronger for the EU member states participating in the incomplete and asymmetric Euro Area than for the euro-outsiders.

To begin with, there were functional spillovers from EMU. In the first decade of EMU, the Single Currency substantially contributed to financial market integration, albeit skewing it significantly in favour of the Euro Area, especially in the banking sector, and thus creating a de facto two-speed financial market integration. The elimination of foreign exchange transaction costs linked to the elimination of national currencies had significant microeconomic benefits in the financial sector — where even hundredths of a per cent have an impact — and far greater than for the trade in goods which was at best limited (Gros 2017). Cross-border banking, cross-border holdings of sovereign and corporate debt, and the use of cross-border collaterals all increased markedly in the Euro Area (see Figure 1).[4] Hence, in this period financial market integration progressed in the EU as a whole, even though banking integration increased more substantially in the Euro Area, bolstered by the harmonisation of debt levels, good economic growth in much of the euro periphery and growing current account surpluses in a number of northern Euro Area member states and, above, all Germany. This can be seen as the first major distortion of EU financial market integration created by EMU.

[3] There are, arguably, previously important critical junctures in monetary integration and differentiated integration. The first was the start of the European Monetary System (EMS) in 1979 and the decision by the UK government not to participate in the Exchange Rate Mechanism (ERM) (Dyson and Sepos 2010). The second was the ratification of the Maastricht Treaty which imposed specific macroeconomic policy and institutional requirements upon member states seeking to participate in EMU's third stage, which the euro- outsiders did not have to meet.
[4] There are no readily available figures for financial market integration in the EU more generally (Gros 2017).

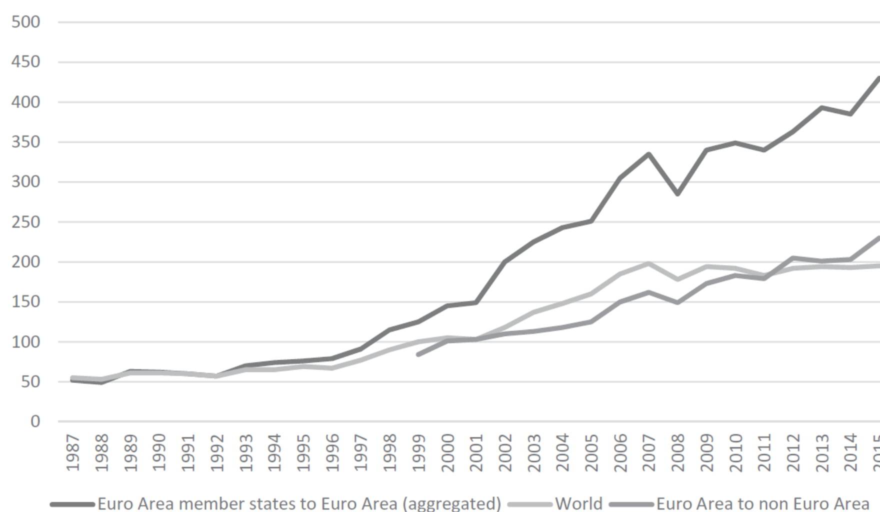

Figure 1. Euro area financial market integration: net international investment position as a percentage of GDP.
Sources: International Monetary Fund; Eurostat: https://ec.europa.eu/eurostat/web/products-datasets/-/TIPSII40

EU, and notably Euro Area, financial market integration brought about a significant increase in bank credit-to-GDP and thus bank leverage, which had both a domestic and a cross-border dimension. The increase in leverage took place throughout the EU but it was greatest in the Euro Area periphery — Spain, Portugal, Greece, Ireland and Cyprus. The increase also eventually brought to the fore the tensions summarised by Schoenmaker (2013) in the 'financial trilemma' of financial integration (especially, cross-border banking), national financial policies (regulation, supervision and resolution) and financial stability. Any two of the three objectives could be combined, but not all three. Whereas the trilemma — which was reminiscent of the functionalist logic of the Mundell-Fleming 'unholy trinity' used to advocated the move to EMU in the 1980s — applied internationally and throughout the EU, it was particularly acute and ultimately untenable in the Euro Area. On the one hand, the Single Currency reinforced financial (banking) integration in the Euro Area. On the other, the Single Currency undermined national financial policies, because the function of lender of last resort could no longer be performed at the national level. Moreover, national bank recovery and resolution powers were constrained by EU fiscal rules. The sovereign debt crisis in the Euro Area, which followed the international financial crisis, can be seen as the extreme

manifestation of the trilemma (Howarth and Quaglia 2016), as elaborated in the following section.

In EMU, there were important cultivated spillovers. The Commission and, especially, the European Central Bank (ECB), played an important role in promoting financial market integration which was seen as essential for the ECB to be able to conduct efficiently a single monetary policy throughout the Euro Area and fulfil its price stability mandate (Gabor and Ban 2016). The ECB decision to treat as equivalent the sovereign debt of all Euro Area member states ensured the near complete convergence of sovereign debt yields — regardless national inflation rates and country-specific risks (ECB 2000, 2002). However, this move also created the second major distortion in financial market integration stemming from differentiated integration, with banks — especially those in northern creditor countries — purchasing larger and larger quantities of euro periphery sovereign debt. The Commission and the ECB actively encouraged the construction of a European (and specifically Euro Area) repo market with the aim of integrating Euro Area securities markets. While Commission efforts started prior to 1999 and focused on the entire EU (The Giovaninni Group 1999), significant progress relied upon ECB action focused on the Euro Area. Gabor and Ban (2016) explain how the ECB performed a unique role in driving financial integration though its role in creating euro liquidity through repo loans (see ECB 2015). By treating all Euro Area sovereign debt as identical collateral for its lending to banks, the ECB in effect encouraged banks participating in the repo market to Europeanize their sovereign collateral.

In the first decade of EMU, there were also EU-wide legislative efforts to promote the completion of the Single Market in financial services. In June 1998, the heads of government and state called upon the European Commission to develop a framework for action to

improve the Single Market in financial services (European Council 1998). In May 1999, the European Commission issued the Financial Services Action Plan, which proposed a set of new financial services legislation that was market-making, that is to say, intended to further market integration (Quaglia 2010; Donnelly 2010; Macartney 2010; Mügge 2010). The adoption of these legislative measures during the 2000s was facilitated by the reform of the framework for financial regulation and supervision in the EU in the early 2000s, the so-called Lamfalussy reforms.

An example of the potential legislative and policy implications of EMU as a form of differentiated integration concerned the clearing of euro denominated assets. In 2011, the ECB issued a policy paper that called for legislation requiring CCPs to be based in the Euro Area if they handled 'sizeable amounts' (specifically, more than 5 per cent of the clearer's total business) of a euro-denominated financial product (ECB 2011a). This recommendation came in the context of a long-standing debate over the authorisation and supervision of CCPs in the European Markets Infrastructure Regulation (EMIR), on which the UK government had won an important concession, prohibiting discrimination against any member state as a venue for clearing services (Howarth and Quaglia 2017). The ECB's euro-clearing policy can also be seen as an example of cultivated spill-over as the ECB sought to extend its remit into new areas in order better ensure financial stability, which was part of the ECB's mandate. The ECB and supportive Euro Area member states argued that only the ECB had sufficient euro holdings to ensure the clearing of large amounts of euro-denominated financial products and maintain financial stability, especially during crisis periods.

The UK challenged the ECB's recommendation before the Court of Justice of the EU (CJEU) on the grounds that the ECB's policy recommendation would restrict the free movement of

capital and infringe upon the right of establishment — two core elements of the Single Market. The ECB responded by a clarification of its clearing house location policy in a November 2011 document (ECB, 2011b), against which, in February 2012, the British government launched a second 'technical' legal challenge. The CJEU found in favour of the UK and swap arrangements between the ECB and the Bank of England were put in place to allay ECB financial stability concerns — thus avoiding what could have become a major legislative division between the Euro Area financial market and the EU financial market.

The principal legislative initiative at the EU level that potentially contributes to legal differentiation on financial services concerns the adoption of a financial transactions tax (FTT), which was to raise revenue for the EU budget (Gabor 2016). In September 2011, the European Commission proposed EU legislation on the FTT after failure in the G20 to make headway on the issue at the international level. After threats by the UK government to veto draft legislation, it was suggested that the tax only apply to Euro Area member states (Torello and Horobin 2011). However, several Euro Area member state governments were also opposed. The member states then agreed to use the EU's enhanced cooperation procedure allowing a minority of member states to proceed with the FTT. In May 2014, ten EU member states agreed to introduce an FTT by the start of 2016. However, the division did not correspond to Euro Area membership. While all participating member states were in the Euro Area — including the four largest national economies — a number of Euro Area member states refused to participate — including Luxembourg, the Netherlands, Finland and Ireland. To date final adoption of the FTT by national governments has been postponed. Thus, this form of differentiated integration remains only potential.

Overall, in the 2000s, prior to the international financial crisis, EMU and the re-launch of financial market integration proceeded almost in parallel. The differentiated integration of EMU had not yet significantly placed the two on competing paths despite the increased intensity of financial integration among Euro Area member states compared to euro-outsiders. However, EMU generated a variety of spillovers that sowed the seeds for further integration in the Euro Area in the following decade, after the 'double whammy' of the financial crisis first, and the sovereign crisis later, as discussed in the next section. Furthermore, the differentiated integration set in place by EMU was path-dependent because the spillovers of EMU applied to Euro Area member states only, not to the entire EU. Finally, it could be argued that the rapid increase in financial market integration supported by the adoption of the single currency, the noted macroeconomic trends, and ECB action on sovereign debt may also have undermined EU-level efforts to adopt market-making legislation designed to ensure durable financial market integration. Indeed, Grossman and Leblond (2011: 414) argue that 'progress in the area of regulatory integration' was substantial, whereas it was less so in 'market-integration'. This might, therefore, be posited as an example of how differentiated integration in EMU worked to distort and even undermine — albeit indirectly — financial market integration.

Crises and Banking Union

From 2007 onwards, the EU was hit by two consecutive crises that threatened at the same time financial stability, financial integration and the Single Currency. The EU's response to the international financial crisis was a host of new financial regulation. The international financial crisis also revealed the weaknesses of existing macroprudential oversight in the EU and the inadequacy of nationally based supervisory models in overseeing integrated financial

markets with cross-border operators. Following the report of the de Larosière Group (2009), the European Systemic Risk Board (ESRB) was established to monitor macro-prudential risks in the EU. The so-called level three Lamfalussy committees were transformed into independent EU authorities with legal personality, an increased budget and enhanced powers (Hennessy 2013). These authorities, namely the European Banking Authority (EBA), the European Insurance and Occupational Pension Authority (EIOPA) and the European Securities Markets Authority (ESMA), were charged with the tasks of issuing binding technical standards and promoting stronger cooperation between national supervisors.

The response of EU institutions and the member state leaders to the sovereign debt crisis was the proposal to complete EMU through the establishment of BU (see De Rynck 2016; Donnelly 2014, Howarth and Quaglia 2016; Epstein and Rhodes 2016). In June 2012, the European Council and Euro Area summit agreed to complete EMU through the creation of BU, which was to be based on four components: a single framework for banking supervision; a single framework for banking resolution; a common deposit guarantee scheme; and a common backstop for temporary financial support. These four components rest on the EU's single rule book on banking that applies to all EU member states. In October 2013, the Council of Ministers approved the Regulation for the establishment of a Single Supervisory Mechanism (SSM). In July 2014, the Council of Ministers and the European Parliament approved the Regulation for the setting up of the Single Resolution Mechanism (SRM) with the Single Resolution Board (SRB). The third and fourth elements — the planned Common Deposit Guarantee Scheme and the common backstop for temporary financial support of the Single Resolution Fund (SRF) — escaped agreement.

BU was necessary in order to deal with the negative functional spillovers of EMU which emerged because of the inadequacy of the existing institutional set up to deal with problems

arising. Exogenous shocks highlighted EMU's incomplete institutional set up and increased pressure on Euro Area insiders to move ahead with further integration to 'fix the problem', so as to avoid the costs of potential EMU collapse (Schimmelfennig 2016). According to this functionalist logic, BU was necessary in order to break the 'doom loop' whereby weak domestic banking systems damaged sovereign fiscal positions, and weak sovereign positions threatened domestic banking stability. Since banks — especially in the Euro Area periphery — held large quantities of government bonds, the sovereign debt crisis weakened the capital position of banks, increasing their funding costs on the market, while the 'fragility of the banks undermined the borrowing status of the sovereign that [had] to stand behind them' (Begg 2012, p. 15; Dell'Ariccia et al. 2018).

As mentioned in the previous section, the acute trilemma in the Euro Area meant that the safeguard of financial stability was outside the control of national authorities and could only be achieved at the Euro Area level. For these reasons, Euro Area member states agreed (in some cases with great reluctance) to transfer prudential supervision and resolution from the national to the supranational level (Howarth and Quaglia 2016). BU was to replace the third element of Schoenmaker's trilemma, namely, national financial policies. All EU member states, including the euro-outsiders that would not join BU, supported more or less the project — which was widely regarded as a solution to the sovereign debt crisis. However, British policy-makers, supported by seven other non-euro member states, threatened to block BU if there were insufficient safeguards put in place for the 'euro-outsiders' (*Financial Times*, 8 November 2012). The British feared the adoption of subsequent financial legislation that would be detrimental to the British financial sector. However, the broader issue of concern was the satisfactory co-existence of more integrated Euro Area member states and the euro-outsiders, which is examined in the next section.

As for cultivated spillover, the ECB was the main supranational institution involved in the making of BU (Epstein and Rhodes 2016; De Rynck 2015), thus assuming, in part, the policy entrepreneurship performed by the Commission in the making of EMU. Prior to the debate on BU, some senior ECB officials (for example, Tommaso Padoa-Schioppa) had expressed support for the ECB to take over supervisory functions (Howarth and Loedel 2005). However, this was not official ECB policy. During the BU debate, the ECB was a keen supporter of all four proposed elements of BU and centralised competences (ECB 2012). Finally, there was also political spillover because EMU gave momentum to cross-border banking and the formation of transnational banking groups, which advocated more harmonised financial regulation and supervision, especially in the banking sector, in order to reduce their compliance costs (Culpepper and Tesche 2018) and challenge 'banking nationalism' (Epstein 2018). 'Forging a European banking market' was a key official objective of BU (Nouy 2017). Transnational banking groups also promoted BU to diminish the risks created by their large Euro Area sovereign debt holdings.

Banking Union and European financial market integration

Banking Union will have significant implications for EU financial market integration. First, BU will contribute to increase financial integration in the Euro Area, hence reinforcing a de facto 'market within a market'. BU ensures better application of the single rule book on banking in BU member states, reduces home versus host supervisory differences, and diminishes opportunities for regulatory and supervisory arbitrage in favour of banks — protectionism. Second, the creation of BU potentially promotes the formation of a coalition of member states with similar interests and thus, potentially, voting as a block on a range of EU financial (banking) regulatory issues. On the one hand, when EMU was set up a similar

concern existed but in the end failed to materialize. The Euro Area hardly ever voted as a block on financial legislative measures (see Quaglia 2010). On the other hand, whereas EMU was mainly about the Single Currency, BU concerns banking, which is directly relevant to financial market integration. Ferran (2014: 9) argues that 'needs and preferences that arise within EBU are likely over time to have spillover effects and to exert an increasingly strong influence over the contents of [EU banking] regulation'. A similar prediction can also be made with reference to supervisory policies and practices (Ferran 2014).

Third, there were concerns regarding potential tensions between Euro Area / BU member state and euro-outsider preferences on the guidelines and technical standards adopted in the European Banking Authority (EBA) to direct EU-wide banking supervision. At the start of negotiations on BU, the UK government feared that a Euro Area / BU majority would be able to impose its preferences on banking supervision on non-Euro Area members in the EBA (*Financial Times*, 13 December 2012). Hence, the UK government demanded an EBA voting reform, whereby any decision by the Authority should be approved by a 'double majority' of member states inside and outside the BU. The European Commission and a number of Euro Area member state governments opposed the voting reform on the grounds that it would result in the creation of two decision-making fora (*Financial Times*, 13 December 2012). Most Euro Area member states also expressed concern that in the event that the number of non-BU member states declined, the UK supervisors would enjoy effective veto powers (*Financial Times*, 8 November 2012).

The outcome was a compromise involving the creation of a 'double majority' system until the number of non-BU member states declined to fewer than four. Thus, participation in the Euro Area was to determine voting rights and inequality was enshrined in EU legislation. A small

number of euro-outsider member state supervisors — five following the expansion of the Euro Area to nineteen members — had the power to block decisions on banking supervision sought by the supervisors from all the Euro Area member states. While the compromise on EBA double majority voting provided some assurance that the Single Market would be protected — insofar as the supervision of banks was concerned —it did so at the expense of the equal treatment of member states.

Fourth, and related to the previous point, there is a potentially uneasy relation between the EBA, which remains responsible for developing guidelines and technical standards on banking supervision for the entire EU, and the SSM, which has the ECB at its centre, and which was assigned both supervisory and regulatory powers. Wymeersch (2014) and Gren (2014) point out the partial overlaps of the EBA and SSM jurisdictions concerning non-legislative guidelines and technical standards for the banking sector. For example, the development of the EBA supervisory handbook that reflects best supervisory practices across the EU and the ECB/SSM supervisory manual must be carefully managed in order to avoid potential inconsistencies. Here several examples of potential divergence can be provided including the Supervisory Review and Evaluation Process (SREP). The EBA is responsible for developing EU-wide guidelines on the SREP. At the same time, the SSM Supervisory Manual also provides for the BU's common supervisory methodologies, such as the methodology for risk assessment and capital and liquidity quantification within the SSM SREP.

Although the ECB insists that the SREP for BU and developed in conformity with the EBA's SREP guidelines (ECB, 2014: 14), the potential for divergence remains. In fact, the less comprehensive that the EBA's guidelines are, the more likely that inconsistencies between

the Single Market and BU will arise — a concern expressed by Andrea Enria, the EBA Chairperson himself (Enria 2013: 8). On the one hand, this convergence-promoting work across BU member states should alleviate the burden on the EBA to promote convergence throughout the EU. On the other hand, the ECB's efforts are 'likely to result in pressure on the EBA to promote an EU-wide model that is very heavily influenced by the ECB's approach' (Ferran 2014: 9-10; see also Lastra 2015). Anecdotal evidence suggests that the ECB has become more assertive in EBA discussions on the matter (Gren 2014). As emphasised by the EBA Chairperson, the danger of creating inconsistent regulatory and supervisory regimes for banks established in the EU and in BU is considerable and the threat to the integrity of the Single Market very real (Enria 2013).

Finally, the most significant impact of BU on EU financial market integration will be in terms of its impact upon the operation of Europe's banks, and above all its largest banks. BU headquartered banks may opt to transform non-BU branches into subsidiaries to enable them to escape ECB direct supervision in the SSM and ensure regulatory and supervisory arbitrage. Or BU headquartered banks may opt to transform non-BU subsidiaries into branches in order to extend ECB supervision. Non-BU headquartered banks might opt for similar strategies depending on national regulatory and supervisory arrangements. The Nordea Bank example highlights the perceived de facto split in the EU banking market that has arisen because of the SSM. In September 2017, Nordea — then the largest Swedish-headquartered bank and the nineteenth largest EU-headquartered bank by assets — confirmed that it was moving its headquarters to Helsinki, merging with its Finnish subsidiary. Officially, Nordea explained the move in terms of wanting its headquarters to be inside BU (Milne 2017). It argued that the move would reduce costs significantly because the bank would be subject to the direct supervision of the ECB which would then coordinate the supervision of its non-BU located

subsidiaries. Björn Wahlrros, Nordea's chairman, explained the move also in terms of the European banking market and competition: 'We see the move as an important strategic step in positioning Nordea on a par with its European peers. The level playing field and predictable regulatory environment offered by the banking union are, we believe, in the best interest of Nordea's customers, shareholders and employees' (quoted in Milne 2017).

Conclusion

This contribution has examined the impact of the differentiated integration created by EMU upon the Single Market in financial services, by combining theoretical insights from neo-functionalism and historical institutionalism. In the 1980s and 1990s, the policy goals of financial and monetary integration reinforced one another, according to the logic of 'One Market, One Money'. The incomplete, asymmetric EMU, which began operation in 1999, was a critical juncture that reinforced differentiated integration in the EU. In the first decade of EMU, prior to the financial and sovereign debt crises, there was no significant tension between EMU and financial market integration — they both largely pushed in the same direction — although the increase in financial market integration in the Euro Area was far greater than in the EU due both to the inevitable impact of removing transaction costs but also due to cultivated spillover through ECB efforts on the repo market and collateral. Principally on the location of euro clearing was there potential for political and cultivated spillover from EMU's differentiated integration but also for conflict between the ECB, Euro Area member states and euro-outsiders.

From 2012, Euro Area member state governments agreed to 'complete' EMU through Banking Union. BU will likely have important implications for the Single Market in financial services (at least, in banking), potentially resulting in 'one money, two markets'. A number of recent developments in both the public and private sectors demonstrate this potential. Although bureaucratic politics might have directed his rhetoric, Andrea Enria, the EBA Chairperson, saw good reason to emphasise publicly the risks of BU undermining the Single Market. To this example, we can add the potential for divergence on insolvency laws. A good number of high ranking EU policy makers — including the SRB director, Dominique Laboureix (2019) — have called for a BU-wide harmonisation of insolvency laws for banks in order to ensure the more effective operation of the SRM. In the private sector, Nordea's decision to relocate its headquarters to a BU member state is only the most obvious of a range of bank decisions that have been shaped by the creation of the SSM and have a de facto impact on the Single Market. Bank decisions over whether to convert branches into subsidiaries or the reverse in order to determine the supervisor — the ECB in BU or a national supervisor outwith BU — with significant implications for bank capital requirements will also shape the real operation of the Single Market in banking. This subject alone merits further examination for which we lack space in this contribution.

Schimmelfenning (2016: 499) notes that 'differentiated integration in one policy area can spill over into functionally related neighbouring policy areas'. The potential effects of BU on the Single Market in financial services have already emerged. Although it is still too early for an overall assessment, either euro area outsiders will align more and more with the regulatory standards set by the euro area, or tensions between the two markets will continue and will

potentially increase because there is no easy solution to this policy dilemma and the euro outsides are unlikely to join EMU just because of these tensions.[5]

Acknowledgements

We wish to thank the anonymous reviewers and the journal editors for their perceptive and constructive comments. We also benefited from presenting our paper at a dedicated special issue workshop at the University of Leiden. We are particularly grateful to the discussant of our paper and the other workshop participants their helpful advice and suggestions.

References

Armstrong, K., and S. Bulmer. 1998. *The Governance of the Single European Market*, Manchester: Manchester University press.

Begg, I. 2012. 'Banking Union: Inevitable, but Profoundly Challenging?', *CESifo Forum,* 13 (4): 15–20.

Buckley, J., and D. Howarth. 2011. 'Regulating the so-called "Vultures of Capitalism', *Journal of Common Market Studies*, 49 (S1): 123-143.

Chang, M. 2009. *Monetary Integration in the European Union*, Basingstoke: Palgrave.

Commission. 1990. 'One market, one money', *European Economy*, 44, 68.

[5] We wish to thank a reviewer for this point

Culpepper, P., and T. Tesche. 2019. 'Death in Veneto?: European banking union and the structural power of large banks', *RSCAS Working Paper*, Florence, EUI.

De Grauwe, P. 2018. *Economics of monetary union*, Oxford: Oxford University Press.

De Larosière, J., L. Balcerowicz, O. Issing, R. Masera, C. McCarthy, L. Nyberg, and O. Ruding. 2009. *The High-Level Group on Financial Supervision in the EU*. Chaired by Jacques de Larosiere, Report, 25 February, Brussels.

De Rynck, S. 2016. 'Banking on a union: the politics of changing eurozone banking supervision', *Journal of European Public Policy* 23 (1): 119-35.

Dell'Ariccia, G., C. Ferreira, N. Jenkinson, L. Laeven, A. Martin, C. Minoiu, A. Popov. 2018. 'Managing the sovereign-bank nexus', ECB Working Paper Series, September, 2177; available at: https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2177.en.pdf?74e347930a6e4ebd8372bc043533f51d

Donnelly S. 2014. 'Power Politics and the Undersupply of Financial Stability in Europe', *Review of International Political Economy* 21 (4): 980–1005.

Donnelly, S. 2010. *The Regimes of European Integration: Constructing Governance of the Single Market,* Oxford: Oxford University Press.

Dyson, K. 2000. *The Politics of the Eurozone*, Oxford: Oxford University Press.

Dyson K., and K. Featherstone. 1999. *The Road to Maastricht*, Oxford: Oxford University Press.

Dyson, K. and M. Marcussen. 2010. 'Transverse Integration in European Economic Governance: Between Unitary and Differentiated Integration', *Journal of European Integration* 32 (1): 17-39.

Dyson, K., and A. Sepos. eds. 2010. *Which Europe? The Politics of Differentiated Integration*, Palgrave Macmillan.

Emerson, M., D. Gros, and A. Italianer, eds. 1992. *One Market. One Money*, Oxford: Oxford University Press.

Enria, A. 2013. 'The Single Market after the Banking Union', Speech at AFME and EBF Banking Union in Europe Conference. Brussels, 18 November; available at: https://eba.europa.eu/documents/10180/490003/2013+11+18+-+AFME+-+EBF+-+Brussels+-+A+Enria

Epstein, R. 2018. *Banking on Markets: The Transformation of Bank-State Ties in Europe* and Beyond, Oxford: OUP.

Epstein, R.A. and Rhodes, M. 2016. 'The political dynamics behind Europe's new banking union', *West European Politics* 39 (3): 415-37.

ECB (European Central Bank). 2000. ‘Guideline of the ECB of 31 August 2000 on monetary policy instruments and procedures of the Eurosystem’, ECB/2000/7, ECB: Frankfurt am Main; available at: https://www.ecb.europa.eu/ecb/legal/pdf/01_a_en_ecb_2000_7.pdf

ECB. 2002. ‘Main Features of the Repo Market in the Euro Area’, *Monthly Bulletin*, October, 45-67.

ECB. 2011a. *Eurosystem Oversight Policy Framework*, 11 September, Frankfurt: ECB; available at: http://www.ecb.int/pub/pdf/other/centralcounterpartyclearingen.pdf

ECB. 2011b. ‘Standards for the Use of Central Counterparties in Eurosystem Foreign Reserve Management Operations’, November, Frankfurt am Main: ECB.

ECB. 2015. ‘The Financial Risk Management of the Eurosystem’s Monetary Policy Operations’, ECB: Frankfurt am Main; available at: https://www.ecb.europa.eu/pub/pdf/other/financial_risk_management_of_eurosystem_monetary_policy_operations_201507.en.pdf.

European Council. 1998. ‘Cardiff European Council, 15 and 16 June 1998: Presidency Conclusions’, SN 150/1/98 REV 1; available at https://web.archive.org/web/20041109152339/http://ue.eu.int/ueDocs/cms_Data/docs/pressData/en/ec/54315.pdf

Ferran, E. 2014. ‘European Banking Union and the EU Single Financial Market: more differentiated integration, or disintegration?’, *University of Cambridge Faculty of Law Research Paper*, No. 29/2014, April, Cambridge.

Gabor, D. 2016. ‘A step too far? The European financial transactions tax on shadow banking’, *Journal of European Public Policy*, 23 (6): 925-945.

Gabor, D., and C. Ban. 2016. ‘Banking on Bonds: The New Links Between States and Markets,’ *Journal of Common Market Studies*, 54 (3): 617-635.

Glöckler, G., J. Lindner, and M. Salines. 2016. ‘Explaining the Sudden Creation of a Banking Supervisor for the Euro Area’, *Journal of European Public Policy* 24 (8): 1135-1153.

Gren, J. 2014. ‘The European Financial Sector after the Crisis: The Banking Union and Beyond’, *Studia Diplomatica*, 67 (2): 69-84.

Gros, D. 2017. ‘One Market, One Money – A Mistaken Argument (post factum)?’, *CEPS Policy Insights*, 2017/05, 16 February; available at: http://aei.pitt.edu/84240/.

Grossman, E., and P. Leblond. 2011. ‘European Financial Integration: Finally the Great Leap Forward?’, *Journal of Common Market Studies* 49 (2): 413–35.

Haas, E. 1958. *The Uniting of Europe: Political, Social and Economic Forces, 1950-1957*, Stanford, CA: Stanford University Press.

Hennessy, A. 2014. ‘Redesigning Financial Supervision in the European Union (2009-2013)’, *Journal of European Public Policy* 21 (2): 151-168.

Hodson D. 2011. *Governing the Euro Area in Good Times and Bad*, Oxford: Oxford University Press.

Howarth, D., and P. Loedel. 2005. *The European Central Bank: The New European Leviathan?*, Basingstoke: Palgrave.

Howarth, D., and L. Quaglia. 2013 'Banking Union as Holy Grail: Rebuilding the Single Market in Financial Services, Stabilizing Europe's Banks and "Completing" Economic and Monetary Union', *Journal of Common Market Studies*, 51 (s1): 103-123.

Howarth, D., and L. Quaglia. 2016. *The Political Economy of Banking Union,* Oxford: Oxford University Press.

Howarth, D., and L. Quaglia. 2017. 'Brexit and the Single European Financial Market', *Journal of Common Market Studies Annual Review* 55 (s1): 149–164.

Howarth, D., and T. Sadeh. 2010. 'The ever incomplete single market: differentiation and the evolving frontier of integration', *Journal of European Public Policy* 17 (7): 922-935.

Jabko, N. 1999. 'In the Name of the Market: How the European Commission Paved the Way for Monetary Union', *Journal of European Public Policy* 6 (3): 475-95.

Jabko, N. 2006. *Playing the Market: A Political Strategy for Uniting Europe, 1985-2005*, Ithaca, NY: Cornell University Press.

James, S. 2016. ‘The Domestic Politics of Financial Regulation: Informal Ratification Games and the EU Capital Requirement Negotiations’, *New Political Economy* 21 (2): 187–203.

Jones, E., D. Kelemen, D., and S. Meunier. 2015. ‘Failing Forward? The Euro Crisis and the Incomplete Nature of European Integration’, *Comparative Political Studies*, 49 (7): 1010–1034.

Juncker, J-C. 2015. *Completing Europe’s Economic and Monetary Union* [Five Presidents’ report], Brussels.

Kudrna, Z. 2016. ‘Financial Market Regulation: Crisis-Induced Supranationalization’, *Journal of European Integration* 38 (3): 251–264.

Laboureix, D. 2019. Presentation, Conference on ‘EDIS, NPLs, Sovereign Debt and Safe Assets’, 14 June, Goethe University Frankfurt am Main.

Lastra, R. 2013. ‘Banking Union and Single Market: Conflict or Companionship?’, *Fordham International Law Journal* 36 (5): 1190-1224.

Leruth, G. and C. Lord, 2015. ‘Differentiated integration in the European Union: A Concept, a Process, a System or a Theory?’, *Journal of European Public Policy* 22 (6): 754-763.

Lindberg, L. N., and S. A. Scheingold. 1970. *Europe's Would-Be Polity. Patterns of Change in the European Community*, Englewood Cliffs: Ithaca.

Macartney, H. 2010. *Variegated Neoliberalism: EU Varieties of Capitalism and International Political Economy*, London: Routledge.

Milne, R. 2017. 'Nordea to move its headquarters to Finland', *Financial Times*, 6 September, https://www.ft.com/content/1ed979fe-9318-11e7-a9e6-11d2f0ebb7f0

Moravcsik, A. 1998. *The Choice for Europe*, London: UCL Press.

Mügge, D. 2010. *Widen the Market, Narrow the Competition: Banker Interests and the Making of a European Capital Market,* Colchester: ECPR.

Niemann, A., and D. Ioannou. 2015. 'European Economic Integration in Times of Crisis: a Case of Neofunctionalism?', *Journal of European Public Policy* 22 (2): 196-218.

Padoa-Schioppa, T. 1982. 'Capital Mobility: Why is the Treaty Not Implemented?', in Padoa-Schioppa, T. 1994, *The Road to Monetary Union in Europe*, Oxford: Clarendon Press.

Padoa-Schioppa, T. 2004. *The Euro and its Central Bank: Getting United After the Union,* London: MIT Press.

Pierson, P. 1996. 'The Path to European Integration: A Historical Institutionalist Perspective', *Comparative Political Studies* 29 (2): 123-63.

Posner, E. 2005. 'Sources of Institutional Change: The Supranational Origins of Europe's New Stock Markets', *World Politics* 58 (1): 1–40

Quaglia, L. 2012. ‘The “Old” and “New” Politics of Financial Services Regulation in the European Union’, *New Political Economy* 17 (4): 515–35

Quaglia, L. 2010a. ‘Completing the Single Market in Financial Services: The Politics of Competing Advocacy Coalitions’, *Journal of European Public Policy* 17 (7): 1007–22.

Quaglia, L. 2010b. *Governing Financial Services in the European Union: Banking, Securities and Post-Trading*, London: Routledge.

Salines, M., G. Glöckler, and Z. Truchlewski. 2012. ‘Existential Crisis, Incremental Response: The Eurozone’s Dual Institutional Evolution 2007-2011’, *Journal of European Public Policy* 19 (5): 665–81.

Sandholtz, W., and J. Zysman. 1989. ‘1992: Recasting the European Bargain’, *World Politics* 42 (1): 95-128.

Schimmelfennig, F. 2016. 'A Differentiated Leap Forward: Graded Membership in EU Banking Regulation', *West European Politics* 39 (3): 483-502.

Schimmelfennig, F. 2015. ‘Liberal Intergovernmentalism and the Euro Area Crisis’, *Journal of European Public Policy* 22 (2): 177–95.

Schimmelfennig, F. 2014a ‘European Integration in the Euro Crisis: the Limits of Postfunctionalism’, *Journal of European Integration* 36 (3): 321-37.

Schimmelfennig, F. 2014b. ‘Differentiated Integration Before and After the Crisis’, in Olaf Cramme and Sara B. Hobolt (eds.), *Democratic Politics in a European Union under Stress*. Oxford: Oxford University Press: 120-34.

Schimmelfennig, F., D. Leuffen, and B. Rittberger. 2015. ‘The European Union as a System of Differentiated Integration: Interdependence, Politicization, and Differentiation’, *Journal of European Public Policy* 22 (6): 764-82.

Schmitter, P. 1970. ‘A Revised Theory of Regional Integration’, *International Organization* 24(4): 836-68.

Schoenmaker D. 2013. *Governance of International Banking: The Financial Trilemma*, Oxford: Oxford University Press.

Story, J., and I. Walter. 1997. *Political Economy of Financial Integration in Europe: The Battle of the System,* Manchester: Manchester University Press.

The Giovaninni Group. 1999. *EU Repo Markets: Opportunities for Change,* Brussels: European Commission: Directorate-General for Economic and Financial Affairs; available at http://ec.europa.eu/economy_finance/publications/pages/publication_summary1096_en.htm

Torello, A., and W. Horobin. 2011. ‘ECOFIN: EU Finance Ministers Clash On Financial Transaction Tax’, *The Wall Street Journal*, 8 November; available at: https://www.wsj.com/article/BT-CO-20111108-708596.html

Van Rompuy, H. 2012. *Towards a Genuine Economic and Monetary Union*. [Four Presidents' report], 5 December.

Verdun, A. 1996. 'An "asymmetrical" economic and monetary union in the eu: Perceptions of monetary authorities and social partners', *Journal of European Integration*, 20 (1): 59-81.

Verdun, A. 2015. 'A Historical Institutionalist Explanation of the EU's Responses to the Euro Area Financial Crisis', *Journal of European Public Policy* 22 (2): 219-37.

Vilpi auskas, R. 2013. 'Eurozone Crisis and European Integration: Functional Spillover, Political Spillback?', *Journal of European Integration* 35 (3): 361-373.

Wincott, D. 1995. 'Institutional Interaction and European Integration: Towards an Everyday Critique of Liberal Intergovernmentalism'. *Journal of Common Market Studies*, 33 (4): 597–60.

Wymeersch, E. 2014. 'The Single Supervisory Mechanism or "SSM", Part One of the Banking Union', National Bank of Belgium Working Paper Research, April, no. 255; available at: https://www.nbb.be/doc/ts/publications/wp/wp255en.pdf