European Research Study Group Quarterly Newsletter

E.R.S.G.-Contemporary Research for a United Europe

September-November 2013 December 2013, Volume 2, Issue 1

Special points of interest:

- 7 November 2013 – The ECB Governing Council lowers the interest rate on the main refinancing operations by 25 basis points to 0.25% and that on the marginal lending facility by 25 basis points to 0.75%. The interest rate on the deposit facility remains unchanged. The Governing Council also decides to continue conducting the main refinancing operations (MROs) as fixed rate tender procedures with full allotment for as long as necessary and until at least 7 July 2015.

In this issue:

ECB Welcomes European Parliament Vote to Create Single Supervisory Mechanism (S.S.M.)

The European Central Bank (ECB) welcomes today's (12/9) vote by the European Parliament on legislation which paves the way for establishing a banking union. Under the Council Regulation conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions (the Regulation), a new system of banking supervision will be created, establishing a single supervisory mechanism for the banks in the euro area (and other EU Member States wishing to join the single supervisory mechanism). This represents a major step towards restoring confidence in the European banking system.

The Regulation will enter into force following approval by the EU Council and publication in the Official Journal of the EU. Its entry into force will enable the ECB to formally initiate all the key preparatory activities, so that it is able to fully assume its supervisory tasks 12 months later.

Today marks a real step forward in setting up a banking union, which is a core element of a genuine economic and monetary union. We will do our utmost to put in place all organisational requirements, with the aim of assuming our supervisory responsibilities one year after the legislation enters into force, and look forward to working with national authorities to contribute to the restoration of confidence in the banking sector," said Mario Draghi, President of the ECB.

In parallel with the adoption of the Regulation, Mr Draghi and Martin Schulz, President of the European Parliament, signed a declaration committing both institutions to formally conclude an Interinstitutional Agreement on the practical aspects of their cooperation on matters related to the single supervisory mechanism.

ERSG Progress Meeting, Warsaw, 28-30/11/2013

The European Research Study Group realized its Fall 2013 Workshop and Progress Meeting that took place in Warsaw, Poland from 28th to 30th November 2013.

The Warsaw School of Economics and, in particular, Professor Elzbieta Kawecka-Wyrzykowska, full-heartedly welcomed the prospect of hosting the Group's meeting as one of the project's partners.

Both the distinguished academic institution and Professor Elzbieta Kawecka-Wyrzykowska have been most accommodating in the project's needs to organize a fruitful event.

It was widely and unanimously accepted that the Warsaw Progress Meeting was crowned with complete success. The meeting was very fruitful as the team produced useful results that will further enhance its works and will provide concrete research orientation in the immediate future.

The meeting set the following milestones:

- January 2014: ongoing communication on works' progress
- Early April 2014: Progress Meeting & Workshop
- Late April 2014: Completion of Papers' Publication
- June 2014: Final Conference in Athens
- Late Aug 2014: Book Publication (structure set in the meeting)

Other useful results were produced regarding the group's research orientation and its further needs in involving policy makers on a local level and reaching out to civil society with regard to the group's research results.

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News & Recent Key Developments

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Special Points of Interest

- The annual growth rate of household gross disposable income increased to 1.1% in the third quarter of 2013 (second quarter: 0.1%). This resulted mainly from increases in compensation of employees, gross operating surplus and mixed income, which were only partly offset by the negative effect of increasing taxes.
- The annual growth rate of household consumption expenditure increased to 1.0% in the third quarter, from 0.6% in the second quarter, while that of household gross saving turned positive to 3.1% from -2.3%.
- The household gross saving rate was 13.0% in the third quarter of 2013, compared to 13.2% in the third quarter of 2012.
- The annual growth rate of gross fixed capital formation of households was -1.1% in the third quarter (second quarter 2013: -3.0%).
- The annual growth rate of household gross non-financial investment was -1.0% in the third quarter of 2013, compared with -4.1% in the second quarter.

Euro Area Economic and Financial Developments

In the third quarter of 2013 the annual growth rate of household gross disposable income increased to 1.1% (second quarter: 0.1%,). The annual growth rate of household consumption expenditure increased to 1.0% in the third quarter, compared with 0.6% in the second quarter. Reflecting these developments, the annual growth rate of household gross saving increased to 3.1% in the third quarter, from -2.3% in the secondn quarter. The household gross saving rate was 13.0% in the third quarter of 2013, compared with 13.2% in the third quarter of 2012.

The annual growth rate of household financing was broadly unchanged at 0.8% from the previous quarter (0.7%), and that of financial investment was unchanged at 1.8%. Household net worth increased at a faster annual rate (0.6%) than in the previous quarter (0.1%).

The annual growth rate of net entrepreneurial income of non-financial corporations increased to 2.3% in the third quarter of 2013, from -1.1% in the previous quarter. The annual growth rate of gross fixed capital formation of non-financial corporations was broadly unchanged at -2.1% (second quarter: -2.2%). The annual growth rate of financing of non-financial corporations was broadly unchanged at 0.8% (second quarter: 0.7%) Non-financial corporations' financial investment grew at a higher annual rate of 1.4% (second quarter: 1.1%).

Debt of households and non-financial corporations as a percentage of GDP stood at 64.7% (third quarter 2012: 65.4) and 102.5%, (third quarter 2012: 104.4) respectively.

Household financing and financial investment were broadly unchanged from the previous quarter (at annual growth rates of 0.8% and 1.8% respectively).

Non-financial corporations' net entrepreneurial income (broadly equivalent to current profits) increased at a higher annual rate (2.3% after -1.1%), while their gross fixed capital formation continued to decrease at broadly unchanged rates (-2.1% after -2.2%).

Total Euro Area Economy

Euro area net disposable income increased at an annual rate of 0.8% in the third quarter of 2013, compared with 0.4% in the second quarter (see Chart 1). The annual growth rate of euro area gross fixed capital formation increased, becoming less negative, to -1.6% (second quarter: -2.9%) (see Chart 2). Gross capital formation declined only slightly in the third quarter (-0.2% year on year), from -3.8% in the second quarter. The prolonged weakness in gross capital formation, accompanied by broadly unchanged euro area savings, led to a continued, though moderate, growth of net lending by the euro area to the rest of the world (corresponding to an increase in the current and capital account surplus).

Chart 1. Growth of euro area net disposable income and its allocation to sectors (annual percentage changes and percentage point contributions)

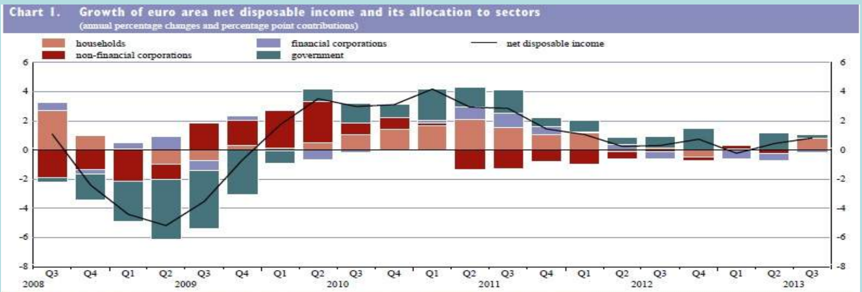
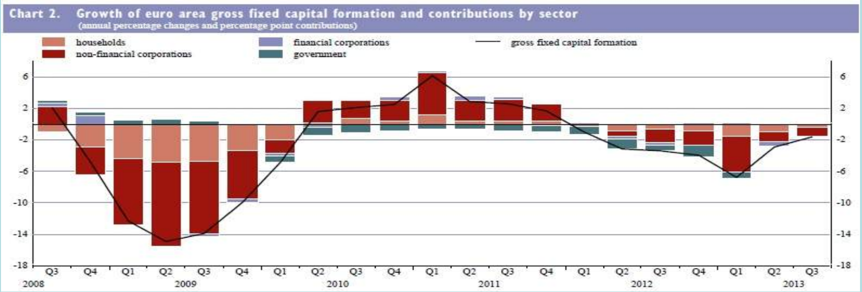


Chart 2. Growth of euro area gross fixed capital formation and contributions by sector (annual percentage changes and percentage point contributions)



(ECB Quarterly Report)

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EMU and Economic Integration

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Impact of the Global Economic Crisis on European Welfare States—Professor Ileana Tache

Over the past two decades reform need arose in the European welfare states, deriving from demographic factors, employment crises and public debt. The evolution of social security benefits since the 1990s reflects that in many EU countries the dismantling of the welfare state is already obvious. These tendencies are in part explained by the reforms of pension and healthcare systems, which account for 70-80 per cent of all welfare state expenditure.

The global economic crisis, the subsequent weaker growth and EU fiscal discipline policy are putting under pressure welfare states in the EU. Cuts in services, as well as tax and contribution increases are further entrenching the process of recommodification which has characterized the reform of European welfare states for years. Nonetheless, in the EU collective coverage of social risks is comprehensive and welfare spending accounts for 16-30% of GDP; this is why the repercussions of the global financial crisis mark a particularly serious “stress test” for the European welfare states.

The unequal economic development and the catch-up processes (typical for the EU) determined also the social dumping. While in countries like Greece, Hungary and Portugal the economic catch-up process has gone along with an expansion of the welfare state, in other states (Estonia, Ireland, Latvia, Lithuania, Slovakia and Spain) the welfare state has been retrenched, in spite of the economic progress.

The global economic crisis had a dual effect for the social security systems: (1) due to higher unemployment, the expenditures of social insurance are increasing and (2) tax and contribution revenues are falling as a consequence of lower economic growth.

Taking into consideration that most European states have used large rescue packages in response to the crisis and to bale out the financial sector, larger deficits have emerged in state budgets and in the budgets of social insurance. Analyzing the state of the public budgets of EU countries in the wake of the global crisis, the European Commission (2009) indicated three measures:

- the reduction of deficit and debt ratios;
- an increase in employment rates and
- social security reforms, especially of pension and healthcare systems.

Because of the poorly performing economy, the EU states are spending more on social protection, with total expenditure having increased by 10% between 2007 and 2010, according to Eurostat.

Benefits for families, pensions and healthcare rose by about 10% in 2010, while unemployment benefits increased by 33% (the average rate of unemployment being 9.7% in 2010 and 2011 and arriving at 10,6% at present). The main sources of funding were represented by social contributions (56%) and general government contributions from taxes (40%).

On average in the EU, old age and survivors benefits accounted for 37% of total social benefits in 2010, and represented the biggest part of social protection benefits in nearly all 27 European countries. The share of old age and survivors benefits in total was the highest in Poland and Italy (61%) and Malta (55%) and lowest in Denmark (38%0, Luxembourg (36%) and Ireland (23%).

It is obvious that the global recession calls into question the financial viability of the current social programmes and that it will roll back a series of welfare state measures, but it could be also a new opportunity to reconfigure and relegitimise social policy, emphasizing the necessity of a unifying social policy concept. The need appears to theoretically redefining the European welfare state in the aftermath of the crisis. The continental corporatist model seems the best fitted for the present challenges of the welfare European states.

Disparities among EU Countries on Social Protection Spending

- The countries that spent the most of GDP on social protection in 2010 were France (33,8%), Denmark (33.3%) and the Netherlands (32.1%). The lowest social protection expenditure was recorded by Romania (17.6%) and Latvia (17.8%).
- The biggest spending per capita after Luxembourg was registered in Denmark and the Netherlands, at more than 40% above the average of EU member states, followed by Austria, Ireland and Sweden at 30% above the average.
- After eliminating cost differences between countries, the social protection expenditure per capita was nearly eight times higher in Luxembourg than in Bulgaria.
- These disparities are a consequence of differences in living standards, of various national social protection systems and of the demographic, economic, social and institutional structures specific to each EU country.

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EMU and Trade Effect

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OCA Theory and EMU Trade Effect: Literature Review—cPhD Georgios Dafnos

Robert Mundell's Optimum Currency Area Theory comprises the cornerstone of the European Monetary Union foundations. The benefits for establishing an OCA are the following:

- Elimination of Currency Risk and Financial Uncertainty
- Reduction of Foreign Exchange Costs → Increase of International Trade
- Convergence and Reduction of Prices of goods and services = Symmetrical External Shocks rather than Asymmetrical
- Decreasing of Foreign Exchange Currency level of reserves available for interventions in currency markets
- Decrease of Interest Rates and enhancement of Competition within the O.C.A.
- Elimination of Speculation towards weak national currencies

The aforementioned benefits come at the cost of surrendering national monetary and exchange rate policy. However: the opportunity cost of the loss of an independent monetary policy is measured on how much effective such an independent policy would have been to address such problems. For example, the more open the economy, the less effective (the more vulnerable) is its monetary policy and the less the cost of giving it up for a centralized Monetary Policy. Hence, a currency devaluation has more significant negative effects (higher prices) on an open economy rather than on a less open economy.

As for Trade, according to theory an OCA facilitates trade creation, Single Market operation. It lowers transaction costs, it diminishes uncertainty in trade from FX fluctuations, it increases price Transparency and lowers segmentation of market, it foster competition and price convergence, it fosters capital market integration and economies of scale due to larger market size. However, significant considerations on OCA theory put forward the argument that for an effective Monetary Union to be established the following prerequisites must be addressed: a) macroeconomic convergence and dealing with countries' different preferences on inflation and unemployment, b) the realization of a Single Market in which Economies of Scale favour big companies may lead to increased concentration in several industries that bears multilevel implications to be addressed and c) some kind of increased Fiscal coordination or fiscal union is needed.

What is still missing:

- Price Convergence (although dispersion in many product categories has declined compared to non-EMU member state)
- Fiscal Transfer System
- Increased Labor Mobility
- Elimination of Structural Rigidities in product and labor markets
- Sense of common supranational destiny

The theoretical examination of the EMU trade effect was inaugurated by Andrew Rose (2000). Rose uses a gravity model for bilateral trade flows to assess the effect of currency unions upon trade. He compares the trade effect of adopting the same currency to that of eliminating exchange rate volatility between separate currencies. According to his findings, the trade effect of common currency areas is profound as "…trade flows among countries in a common currency union are on average three times higher than those among countries that are not into any". Subsequent refinements left the estimated effect above 50%.

OCA Theory

- An Optimum Currency Area is a geographic region that adopts a single currency for optimizing economic efficiency.

- General Criteria for the establishment of an O.C.A.

1. Labor and Capital Mobility - Price and Wage Flexibility and Convergence
2. Openness of the Participating Economies
3. A Risk Sharing System: monetary transmission mechanisms
4. Similar Business Cycles and Real Economic Convergence
5. Commonality of Destiny

- Endogenous Criteria for a member state to participate to an O.C.A.

1. Volume of Trade of a Candidate Country
2. Diversified Production of a Country's Economy
3. Fiscal Policy Coordination-Decentralized but mechanism of fiscal transfers to depressed regions should exist
4. Similarity of Structural Characteristics of member economies.

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OCA Theory and EMU Trade Effect: Literature Review—cPhD Georgios Dafnos (cont'd)

Other contemporary empirical research that reinforce these early findings:

- Bun & Klaasseen (2002): they find a total cumulative increase in Intra-EMU Exports of 3.9% in 1999, 6.9% in 2000, 9.6% in 2001 and 37.8% in the long run.
- Flam & Nordstrom (2003): "…the introduction of the Euro has increased trade between the Euro countries by 15% and by 7% with non-members on average for the period 1998-2002".
- Barr et al (2003): Intra-EMU Euro trade effect 20% on average for the research period 1988-2001.
- Faruquee (2004): He finds that the Euro has a positive effect on the Intra-EMU trade estimating an increase by 7% to 10% for research period 1992-2002. He also contemplates the relative trade gains and losses between EMU states:

1) Wide dispersion on a country level that appear to widen in the long-run.

2) Some countries were better placed for reaping the trade benefits from the single currency. This depends on several factors: a) Trade Openness: greater exposure to trade→ greater benefits, b) Trade Patterns: certain types of trade benefit to greater extent. (e.g. Countries with lower initial shares of intra-industry trade-IRL, FIN, PORT- are on the low end in terms of relative gains, in contrast to GER-SPN-BELG), c) Exchange Rate Volatility: higher volatility prior to EMU, greater benefits due to decline of exchange rates uncertainty, d) Market Flexibility and Reforms: higher flexibility in shifting resources, adaptability of production, limiting entry and exit costs→ higher benefits, e) Structural Characteristics of member states' economies: economies that have solid economic and productive structures, healthy bureaucracy and are export their products benefit more.

3) Trade Creation VS Trade Diversion varies across countries.

- Berger & Nitsch (2005): They view EMU in the wider context of a process that led to greater economic and monetary integration in Europe since WWII. Thus, they include a time span in their data analysis as far back in the past as 1948. Their findings verify that there has been steady rise in trade between European countries for five decades, and this trend continues with the introduction of the Euro having negligible effect. However, for the period 1992-2003 their analysis point to a 5% increase in Intra-EU trade due to the introduction of the Euro.
- Baldwin (2006): the Euro boosted intra-EMU trade b 5% to 10% on average. There is evidence in his findings that this was done not only through decreasing trade costs by increasing competition as Eurozone firms engaged in export to other Eurozone markets increased after the Euro's introduction.
- De Nardis-De Santis-Vicarelli (2007): Euro trade effect in Intra-EMU countries presents a positive effect in trade flows by 4% to 5%.
- Angkinand-Permpoon-Wilhborg (2009): Euro trade effect in Intra-EMU countries presents a positive effect in trade flows as high as 7%.

Summing up, there is convincing evidence that the introduction of the Euro has fostered trade increase (both intra-EU and inter-EU) having trade creation effects. Moreover, it has facilitated financial integration among its member states, that could lead to welfare gains. Up till now, trade gains have been distributed unevenly reflecting the fact that some countries were better placed to reap the trade benefits compared to others due to better structural and economic foundations they had laid. Trade integration findings reflect the increased economic divergence that exists between EU member states.

Further Empirical Research on EMU Trade Effect

- Rose's work instigated further empirical research based mainly on the following principles:

1) Gravity model analysis augmented with different variables and time span, depending on the scope of the analysis.

2) Distinction between Euro adoption and exchange rates volatility effects.

3) The sample of countries has to be from those participating in the EMU.

4) Not only cross section analysis, but also time dimension analysis should be included.

5) Political developments and other ties between EMU countries promoting integration must be taken into account.

EMU Trade Effect

- IEMU trade effect may not be attributed only to the elimination of exchange rates uncertainty and common currency but also to other related factors such as:

1. increased credibility of ECB,
2. price transparency that leads to increased competition and productivity,
3. higher macroeconomic stability,
4. reduction of trade costs

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EMU, Economic Governance and Institutions

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The Concept of Banking Union

- The establishment of a banking union for EMU and EU countries depends on choices concerning a number of open issues having alternative solutions. The concept of banking union involves issues like:

1. A Single rulebook for the European financial market
2. Single Supervisory Mechanism (SSM)
3. Single Resolution Mechanism, with a Single Resolution Fund, and a fiscal backstop
4. Harmonization of the Deposit Guarantee Schemes.

- The first two issues are allocated to the Central bank of the EU. The last two issues are of great importance to member states and are therefore still open in certain areas.

- The formation of a banking union eliminates the responsibility of states to perform bank rehabilitation at the expense of the public debt, which is ultimately repaid by the citizens themselves.

- The banking union should be supplemented by a single institution for the control of banks, a fund for bank rehabilitation and liquidation, a general system of deposit guarantees and, eventually, with the possibility of the EMU issuing EU bonds on the financial markets (common, backed by a joint guarantee of all the member states).

The Banking Union and the Framework for the Economic Governance of the EMU—Professor Oskar Kovac

The main goal of the Rome Agreement on the formation of the European Economic Community was the creation of a customs union and a single internal market over the entire EEC area. Almost 60 years later, the European Union has elements of a political union: the European Parliament and its executive organs, the European Commission, the Central Bank and a "constitutional" court. Still, the EU possesses only those political elements that its national member states voluntarily transferred to the Union organs.

When, on the basis of the Maastricht Treaty, the present Economic and Monetary Union was formed, together with the Central Bank and a single currency (the euro), questions regarding the direction of economic and development policy over the entire EMU space gradually, inevitably came up. Some of the most acute issues are the following:

- A detailed and carefully constructed system of governance of the economies of the entire European Union (that is, of both parts of the EMU) with the key systems and instruments of contemporary economic policy for a market economy.
- A monetary system and policy with the functions of a central bank, with influence on monetary aggregates, monetary policy instruments (inflation targeting, key interest rate setting, maintenance of a desired ratio (between level and changes) of prices, interest rates and exchange rates
- Fiscal system and policy. Without these, it is impossible to conduct successful macroeconomic policy. Impulses from the real economic sector are aggregated and registered in national balance sheets that show the formation and distribution of the gross national product, and its use for personal, investment and budget consumption.

The financial and economic crises that have hit the world, including the EU, have revealed the EMU's construction problems,. The establishment of special facilities and institutions for enhancing economic governance of the EMU were set while the sovereign debt crisis was unfolding.

The first such institution, the European Financial Stability Facility, was formed by the EMU countries as an independent company. It approved loans for the refinancing of debts of financially troubled countries, intervenes in primary debt markets and in secondary markets only upon recommendation of the European Central Bank. EFSF's capital and functions were assumed by the ESM, which substituted it and was founded by the EMU member countries, with the option of other EU member countries outside of the EMU also joining. All the funds used by the ESM in helping a country in financial distress are given under precisely defined conditions, most often on the basis of a program of adjustment and reform, similar to the IMF's condition-based programs. Thus, the ESM has become the EMU's version of the IMF.

The establishment of the Single Supervisory Mechanism and th Single Resolution Mechanism is also seen in the context of EMU Economic Governance. The Single Supervisory Mechanism (SSM) places the European Central Bank (ECB) as the central prudential supervisor of financial institutions in the euro area (including approximately 6000 banks) and in those non-euro EU countries that choose to join the SSM. As of November 2014, the European Central Bank will directly supervise the largest banks, while the national supervisors will continue to monitor the remaining banks. The main task of the ECB and the national supervisors, working closely together within an integrated system, will be to check that banks comply with the EU banking rules and to tackle problems early on. The Single Resolution Mechanism (SRM) will apply to banks covered by the SSM. In the cases when banks fail despite stronger supervision, the mechanism will allow bank resolution to be managed effectively through a Single Resolution Board and a Single Resolution Fund, financed by the banking sector. Its purpose is to ensure an orderly resolution of failing banks with minimal costs for taxpayers and to the real economy.

The Evolution of the Romanian Capital Market —

Assoc. Prof. Anca Bandoi—Ascoc. Professor Mirela Cristea

The emergence and later spread of the financial crisis have clearly highlighted the problems generated by an overgrown financial sector which favours risky (toxic) financial products. An international financial context which favoured large movements of capital over short periods of time (volatile) has complicated the central banks' strategies of keeping financial stability. Added to all this was the wrong notion that the complete openness of capital markets cannot cause problems. Instead, reality has proven that the smaller and the more open an economy is, the more exposed to problems created by intense capital fluxes it gets. It is the case with many emergent economies, either when massive capital enters or exits. On the other hand, a more permissive economy that lacks protecting measures would enhance the risk of destabilizing movements of capital. In this case, the question arises: what can be done to have a capital market as a viable alternative to bank financing, at the same time ensuring the economy's stability? There is no single answer, but all of them hint at controlling movements of capital through a mix of monetary and financial measures in order to avoid speculative bubbles. In the Monetary Union of the economically developed countries, the term of macro-prudentiality is used when such measures are employed to avoid speculative bubbles and to lower systemic risks.

The above analysis highlights an essential problem for Romania's macroeconomic policy, namely how to develop the capital market without causing great financial instability.

Analyzing the evolution of the capital market in Romania during the worldwide crisis, we can state the following: in 2008 there was a rise in the number of the intermediaries which acted as participants in the capital market, namely five new participants (four crediting institutions: BCR, MKBROMEXTERRA BANK, CREDIT EUROPE BANK, BRD – GSG and one intermediary from a member state, Raiffeisen Centrobank AG Viena). Despite this, the interest for Exchange transactions dropped.

In 2009, the Romanian capital market saw a decrease in participants' number compared with the end of 2008 because the struggling Romanian economy combined with the worldwide economic crisis. 2010 was a difficult year for the capital market participants because cash was within low limits, continuing the previous year's trend. Moreover, the cost of shares at the Exchange stagnated, as opposed to the rising tendencies in 2009.

2011 did not fulfill the expectations of a recovery in the rising of capital markets. The BVB capitalization rose only 8.07% as compared to the previous year and only 18% of the shares listed by BVB rose, while 82% dropped as compared to 2010. The cash flow was better, but almost exclusively because of the special transactions with Fondul Proprietatea's shares.

2012 continued the lateral evolution of Stock Exchange indicators that begun in 2010, proving the optimistic predictions at the beginning of the year had been wrong. Cash on the market dropped 25% from the previous year, while Stock Exchange capitalisation rose by 38%. A number of 36 shares that were listed on the Exchange regulated market rose in price, while 40 shares dropped, while the price of only three shares was constant. Big events on the capital market were few, the biggest being the secondary public offer of selling the Transelectrica share packet

In 2013, the share market in Romania got rid of the stagnating tendency of the previous years, many of the listed shares' price rising. From this point of view, it was a good year for Stock investors. The official indicator of the Stock Exchange of Bucharest, BET, had an annual performance of +26.10%, the best since 2009, and with positive perspectives. Daily cash mean on the Stock Exchange regulated market rose by 50.6% as compared to the previous year, while the Exchange capitalization similarly rose by 36.9%.

The cash flow on Rasdaq market kept very low. The transaction value was of only 301,9 million lei in 2013, as compared to 218,6 million in 2012, 575,4 million in 2011 and 605,1 million in 2010.

Romanian Capital Market: Volatility and Correlations—Euro Adoption Advantages

- The correlation of the Romanian stock market with those in the Czech Republic and Hungary further dropped in intensity in 2013 (PX, WIG and BUX are the indicators of the Stock Exchanges in the Czech Republic, Poland and Hungary).
- the corelation with the Polish market got stronger, with a relation indicator between BET and WIG of 0.87 in 2013 (0.20 in 2012)
- The volatile nature of BET, calculated as a standard deviation from daily yields, has continually dropped in 2013 to 0.71%, as opposed to 1.04% in 2012, 1.39% in 2011, 1.89% in 2010, 2.58% in 2009 and 2.68% in 2008.
- The euro adoption advantages for the Romanian financial market: lower cost of currency transactions, on the euro zone; eliminate the exchange rate risks; scale economies and a wider variety of financial products at lower costs; financial stability and better functioning of the payment system; lower interest rates.

EMU, Financial Integration & European Banking System

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The European Sovereign Debt Crisis and the Role of CDS—Prof. El. Thalassinos—Assoc. Prof. Th. Stamatopoulos

The flows of funds in the international financial markets worldwide have been extremely unstable since the eruption of the global financial crisis in August 2007 and even more since the collapse of the Lehman Brothers in September 2008. Investors look for safe heaven investments during periods of crisis with high volatility in the market. The indebtedness of the private sector, regardless of the agent (households or firms of any kind) or the instrument (real estate, stocks or derivatives in organized stock exchanges or over-the-counter or even baked securities like CDOs), launched a global financial crisis in 2007, that ended up affecting the real economy worldwide throughout the banking crisis in 2008.

Quantitative easing" had been the main response of the governments driving them to raise the public sector's debt radically. The pressure imposed on the financial markets in 2008 signified a diminution of liquidity among insolvent financial institutions, compelling at the same time many banks and investors to send capital back to their countries in order to finance investments and pay for restructuring. Accordingly, the capital available to the real economy became strictly confined and triggered a great global recession. followed by enormous loss in productive employment rates.

The Eurozone crisis, still creeping, has seriously affected the growth perspectives of the region by converting private indebtedness to liquidity and banking crisis. The latter eventually turned into sovereign debt crisis in 2010, with architectural deficiencies as well as pro-cyclical, weak and limited economic response attributed to its policy makers (Cartapanis, 2010). All of the above have posed serious threats to the banking system and the steadiness, in general, of the financial sector. The ongoing sovereign crisis in Europe led to spillover effects in the trade sector and in the financial markets in 2011 and 2012.

According to the numerous recent academic research works, the possibility of default in a country is positively correlated to sovereign debt. In equilibrium, sovereign bonds are priced to compensate the lenders for the risk posed by a country, including the risk of a country's default and the risk of its debt restructuring. Interest rates increase along with the level of debt, leading to a higher default probability and to a lower debt recovery rate. The development of various theories was based on the effect of macroeconomic and financial variables on the determination of the CDS spreads, as in the works of Jamal (2011), Arghyrou and Kontonikas (2011) and Grammatikos and Vermeulen (2012). Various theories based on the works of Beirne and Fratzscher (2013), Calice, Chen and Williams (2013) and Aizenman, Hutchison and Jinjarak (2013) have emphasized on the financial discrimination against "high-risk" countries.

Our findings on market pricing of Euro Area member-countries' default risk reveal a major role in the downgrade valuations of CRAs forward one quarter, the current yield on five-year governments' bonds, a period lead of a fiscal space variable if expressed with the fiscal balance as a percentage of the tax base and lag if expressed by the public debt as a ratio to the tax base. Self-fulfilling expectations and herding behavior may be detected from the forward looking redictors, such as either the CRAs valuations or the relevant fiscal space, justifying the call for second generation crisis models for ensuing the crisis in Eurozone. With a view to the fiscal space, our findings are generally in accordance with those of Aizenman, Hutchison, and Jinjarak (2013).

Market pricing discrimination between (South West Euro Area Periphery countries) SWEAP and non-SWEAP countries has been statistically and economically confirmed. Specifically, we estimated asymmetric market pricing on average 30 basis points less than the mean-Eurozone's for the non-SWEAP country-members in 2009 (at the "end" of the global financial crisis) and also on average 47 basis points more for SWEAP in 2010 (at the peak of the Eurozones crisis.

We found strong evidence supporting the hypothesis of structural change on themarket pricing Model of sovereign default risk, the year 2010 set as threshold between two sub-periods, period 2008-2010 of global financial crisis and period2011-2013 after that.

The main limitation of this study pertains to the fact that it does not take explicitly into account the endogeneity between CDS and bond markets.

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