The Political Economy of the E.M.U.
E.R.S.G.
Contemporary Research for a United Europe

European Research Study Group Quarterly Newsletter

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

March-May 2014 June 2014, Volume 2, Issue 3

Special points of interest:

- 2 May 2014 – EC, ECB Post -Program Conclusion Meeting: The outlook for Ireland has continued to improve since the conclusion of the EU/IMF -supported programme. Against the backdrop of a general decline of sovereign yields, demand for Irish assets from private investors is high as the authorities are resuming normal market borrowing.The economic recovery and the decline in headline budget deficits continue, while other reforms advance.

In this issue:

Lifelong Learning

EC, ECB & IMF Final Review Mission to Portugal

The economic recovery is broadening. Exports continue to drive economic growth, while private investment and consumption have also started to pick up. Unemployment is expected to decline further, in line with the moderate economic recovery expected in 2014 and 2015.

The budget deficit targets of 4 percent in 2014 and 2.5 percent in 2015 have been reaffirmed. The deficit target in 2013 was reached by a comfortable margin and budget performance in the first months of this year was better than expected. However, there are important downside risks to the budget, related to continuing legal challenges which contribute to the pressures for the substitution of higher quality measures with measures of lower certainty and quality. Fiscal accounts may also be impacted by possible changes in the treatment of deferred tax assets which are still under consideration and by the statistical treatment of efforts to more efficiently manage the debt overhang of some state-owned enterprises. The Government has presented its medium-term fiscal strategy until 2018, complying with commitments under the program.

The stabilisation of the banking sector has continued, but financing conditions in the economy remain difficult. Bank capitalization has been significantly strengthened during the program and dedicated resources remain available to support the banking system, in compliance with EU state-aid rules, should additional capital needs arise. Market liquidity conditions have also continued to improve. The trend in non-performing loans has stabilised, although operating conditions for banks remain challenging. Access to bank credit at reasonable cost is still constrained for viable but highly indebted companies, notably for small and medium-sized enterprises.

Portugal's access to sovereign debt markets has improved markedly amid robust investor demand and sharply declining yields. The program remains on track to be concluded, following the completion of this final review. (ECB, 05/2014)

E.R.S.G., Nis Progress Meeting, 8-10/05/2014

The European Research Study Group realized its Spring 2014 Workshop and Progress Meeting at theUniversity of Nis, Serbia.

The University of Nis, Serbia and, in particular, Professor Dejan Spasic, Professor Assoc. Prof. Tamara Milenković-Kerković and Assoc. Prof. Ksenija Denčić-Mihajlov, full-heartedly welcomed the attendees of the Group's meeting from 08/05 to 10/05.

The University of Nis Vice Rector for International Relations Dr. Vesna Lopicic addressed the meeting with a warm welcome speech to the participants.

The meeting set major milestones: such as the deadline for Papers and the deadline for Final Book's Chapters.

Moreover, the Concluding Meeting and the Final Conference of the Research Group was set ti take place in Athens from 18th to 20th June 2014.

Furthermore, the Group discussed all latest developments on the EMU front and how they could be addressed from the ongoing research work. There was a unanimous decision that the Group's research works should follow contemporary developments until early June, in order to start processing the papers that have already been produced as input for the Final Book

The Final Book's structure and template was agreed as well as some critical case studies per country. The Meeting tackled critical issues that are directly related to the project's conclusion paving the way for the Athens Final Conference.

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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 decreased to 0.8% in 1/2014 (previous quarter: 1.7%). This deceleration resulted mainly from decreasing net property income and net social benefits, while compensation of employees continued to grow.
- The annual growth rate of household consumption expenditure was broadly unchanged at 1.2% in the 1/2014 (after 1.1%), while that of household gross saving decreased to—1.8% from 5.6%. The household gross saving rate was 13.0% in 1/2014, compared to 13.1% in 1/2013.
- The annual growth rate of gross fixed capital formation of households was 0.2% in the 1st quarter (previous quarter: -1.2%).
- The annual growth rate of household gross non-financial investment was 0.2% in the first quarter of 2014, compared with -0.8% in the previous quarter. This increase,together with the decrease in gross savings, led to a slight decrease of household net lending.

Euro Area Economic and Financial Developments

In the first quarter of 2014 the annual growth rate of household gross disposable income decreased to 0.8% (previous quarter: 1.7%). The annual growth rate of household consumption expenditure was broadly unchanged at 1.2% in the first quarter (after 1.1%). Reflecting these developments, the annual growth rate of household gross saving decreased to -1.8% in the first quarter, from 5.6% in the previous quarter.

The household gross saving rate was 13.0% in the first quarter of 2014, compared with 13.1% in the first quarter of 2013. The annual growth rate of household financing was broadly unchanged at 0.3% (fourth quarter: 0.2%), and that of financial investment was broadly unchanged at 1.5%(fourth quarter: 1.6%). Household net worth increased at a higher annual rate of 1.9% (fourth quarter: 0.6%).

Net entrepreneurial income of non-financial corporations increased at a lower annual rate of 0.2% in the first quarter of 2014, after 1.4% in the previous quarter.

Gross fixed capital formation of non-financial corporations increased at an annual rate of 3.9% after 1.5% in the previous quarter. The annual growth rates of financing decreased to 0.5% (fourth quarter: 0.8%) and that of financial investment decreased to 1.0% (fourth quarter: 1.4%).

Debt of households and non-financial corporations as a percentage of GDP stood at 63.9% (first quarter 2013: 65.2) and 104.4%, (first quarter 2013: 106.5) respectively.

Household financing and financial investment grew at broadly unchanged annual rates of 0.3% (fourth quarter 2013: 0.2%) and 1.5% (fourth quarter: 1.6%) respectively.

Non-financial corporations' net entrepreneurial income (broadly equivalent to current profits) increased at a lower annual rate (0.2% after 1.4%), while their gross fixed capital formation increased at an annual rate of 3.9% after 1.5% in the previous quarter.

Total Euro Area Economy

Euro area net disposable income increased at an annual rate of 1.7% in the first quarter of 2014, compared with 1.4% in the fourth quarter of 2013 (see Chart 1). Euro area gross fixed capital formation grew an annual rate of 2.3%, after decreasing in the previous quarter (-0.2%, see Chart 2). Gross capital formation, which includes in addition inventories, grew an annual rate of 1.8%, after decreasing in the previous quarter (-0.3%). The increased gross capital formation was broadly matched by increased euroarea savings, resulting in a continued 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).

(ECB Quarterly Report)

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

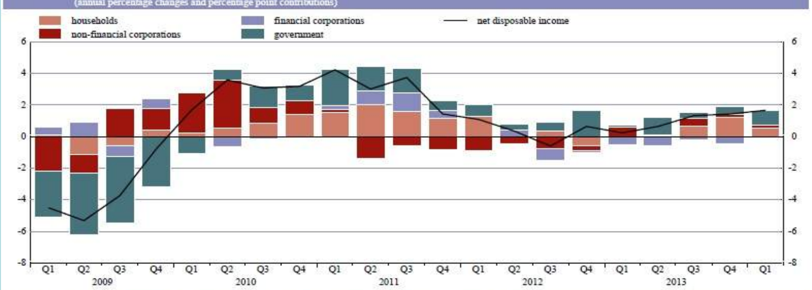
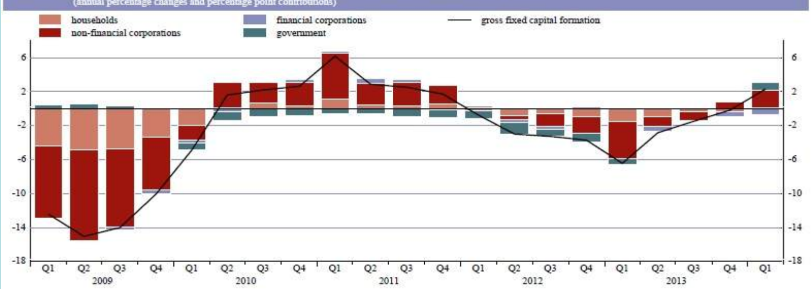


Chart 2. Growth of euro area gross fixed capital formation and contributions by sector (annual percentage changes and percentage point contributions)



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EMU and Public Sector

March-May 2014

June 2014, Volume 2, Issue 3

System State-Aid is Serbia and Western European Countries: Impact on EU Integration—Professor Tamara Milenkovic-Kerkovic

Uncontrolled granting of state aid may distort competition between market participants who receive and those who do not receive state aid. Thus, the state aid control is an important segment of the competition policy. The regulatory role of the state institutions is essential in order to achieve the objectives of competition policy. State institutions define the rules that regulate fair and loyal competition. Measures to protect the competition conditions are directed, from one side, to the companies, and from the other side, to the activities of the state and state aid control. Establishing a system of state aid control is also an important requirement of the integration process of countries in the European Union (EU). The Stabilisation and Association Agreement (SAA) is the main instrument through which the EU seeks to ensure the acceptance of the rules of the European common market by the countries that are potential candidates for membership. The two basic elements of the SAA are trade liberalization, and the creation of a single market and harmonization of legislation, as an essential prerequisite for the realization of the first element. The most important sectors of adjustments relating to the functioning of the single market are competition and state aid. The Western Balkan countries assumed, among other things, the obligation of building institutions for state aid control by signing this agreement. The agreement requires a gradual harmonization of legislation with the EU acquis (acquis communautaire) in this area.

All analyzed countries, except Bosnia and Herzegovina, responded within two years from the signing of the Stabilization and Association Agreement to his requests, and adopt the Law on State Aid Control and form an operational regulatory body for control. It is logical to expect that those countries that started among the first with the construction of the system of state aid control through the signing of the SAA, and then through the adoption of relevant laws, have the most advanced systems.

However, the situation is different. Croatia stands according to the development of the system and the number of individual regulations, which regulate a particular area of the complex issues of state aid among the analyzed countries. The second country, according to system development, as well as, according to the number of adopted regulations is Montenegro. Serbia and F.Y.R.O.M. are lagging behind in this regard. Bosnia and Herzegovina still has not authoritative laws and secondary legislation in the field of state aid. Bosnia is at the beginning of the establishment of the system of state aid control.

Comparative legal analysis has shown that there is an inverse correlation between the level of development of the system of state aid control and the potential time required to obtain the status of a full member of the European Union. In fact, Croatia has the best organized and most developed system of state aid control among the analysed Western Balkan countries. Croatia is the only country in the region that successfully completed the process of joining and became the EU member. It can also be concluded that the development of the system of state aid is not crucialy determined by the length of a period of its development. It is more direct consequence of the will and readiness of authoritative actors that the system does not formally meet the set of pre-accession commitment, but functional pillar and subsystem of the wider system of competition protection in the market.

The initial assumption of the research about the existence of a positive relationship between the level of development of the system of state aid control and the success of countries in the process of the European integration is also confirmed by the results of the correlation analysis. Countries that have among the first adopted the Law on State Aid Control received candidate status also among the first. A high positive correlation was observed between the development of the system of state aid control and the date of obtaining the candidate status.

Western Balkans EU Accession

- The Western Balkan countries are committed to the adoption of a legal framework for state aid control by signing the SAA. Prior (ex ante) and subsequent (ex post) control of all new state aid measures, and compliance of existing measures with the rules that will be established are enabled in this way.
- Positive effects of economic policy-making and rational budget planning and implementation of suitable policies for regional development were expected. It is anticipated that the Western Balkan countries within the prescribed period (two years after the signing of the SAA) form an operationally independent body that exercised control over the state aid allocation. This body would perform ex ante and ex post control of state aid, with jurisdiction of granting state aid.
- The ultimate aim of these measures was to review the composition of state aid granted, and efforts to change its size and structure.

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EMU, Macroeconomic Convergence and Fiscal Integration

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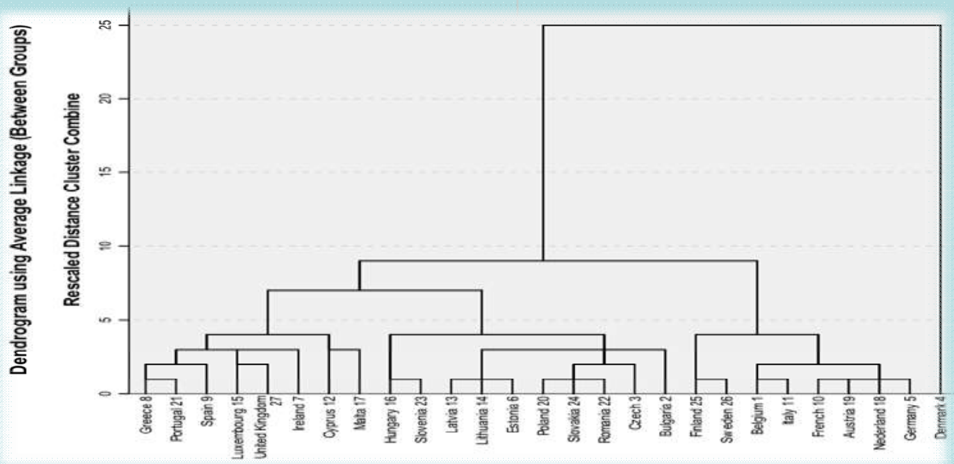
A Quantitative Approach to Measure Tax Competitiveness between EU Countries — Ass. Professor Konstantinos Liapis

The tax system applied in a country has a serious impact on cross-country competitiveness, something that, in turn, impinges strongly on the actual economy of common markets such as the EU and the differences among tax regimes diversifies homogeneously. The differences and imbalances between EU countries reflect the different tax regime structures applied and this problem seems to have also a spatial character imposing a significant regional problem for the EU, and especially EMU countries, that already have a common currency and monetary policy. On the other hand, the mobility of productive factors is directly related to the country tax-regime differences, government budget funding from tax revenues and rates, which are the main fiscal policy tools. 'Taxing the rich' is a policy based on taxes increase against the recent financial crisis and carries a considerable populist appeal. A key problem with the current debt crisis is that public spending is increased with slower pace than decreased tax revenue.

The general rule (strongly positive correlation between tax rate and tax revenue) is not followed by the countries with significant differences in tax legislations and problems in collecting taxes. Musgrave and Musgrave (1973) argued that, obviously, the tax rate directly affects the amount of tax revenue and deviations from the rule of proportional change, between tax rate and volume of tax revenues, indicate: instability in tax performance among countries; the existence of problematic tax legislation in the countries (tax-free, tax deductible, tax exempt amounts and differences in tax rates per incremental level of tax base); tax evasion or failure of tax authorities in collecting taxes or replacement taxable amounts with tax exempt income or with income classified to other tax base with lower tax rate.

Our research has conducted an analysis of the tax regimes of the EU countries are analyzed for the period from 1995 to 2011. The corporate and other income taxes remain at a lower level against Personal income taxes in many countries and as an average in the EU market, which denotes that personal income remains as the main income base for the direct taxation. Corporate tax rate has a positive and significant relation with revenues from corporate tax. However, corporate tax regime does not provide substantial outcomes. Policies that provide convenience for direct investments will substantially increase the tax revenues.

Using Euclidian Distance and average linkage between groups, for all kinds of taxes the cluster of similarities between EU countries is produced. According to this global estimation, EU countries are grouped in (3) main separate groups, as they appear in the following table, with obvious evidence that in the classification there is a spatial character .



Special Points of Interest

- The study shows the significant difference in performance between EU countries when collecting VAT as well as the significant difference in the tax structure on income (Personal and Corporate) between EU countries.
- Corporate tax remains at a lower level against Personal income taxes in many countries and on average in the EU market which denotes that personal income remains as the main income base for the direct taxation. Significant decreases also exist in the tax rates of direct taxes for all EU countries.
- The decreases of tax rates on corporate income remain at a higher level against tax rates on personal income. Low homogeneity exists in the volumes of personal income tax revenues as well as in the volumes of corporate income tax revenues. Cyprus, Malta and Luxembourg as international corporate centers have high level of volumes and, on the other hand, Germany has the lowest volume as % of GDP from all other countries.

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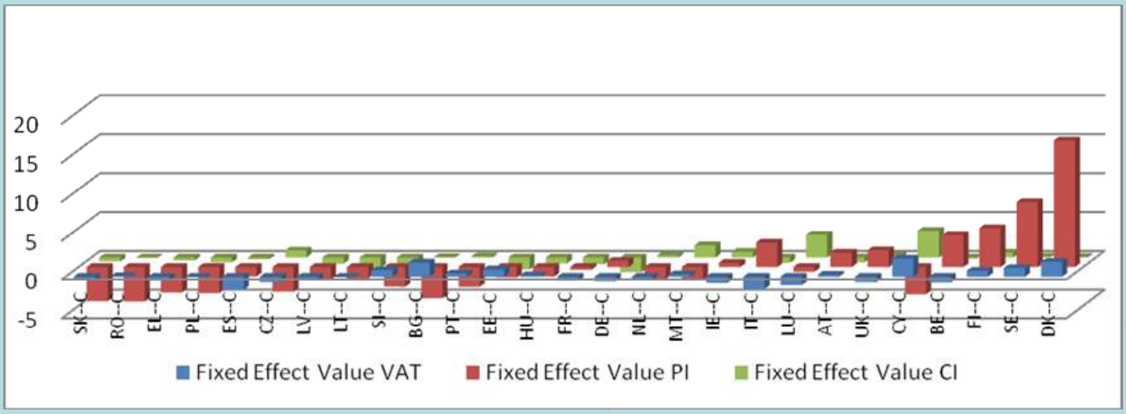
A Quantitative Approach to Measure Tax Competitiveness between EU Countries — Ass. Professor Konstantinos Liapis (cont'd)

The differences and imbalances between EU countries reflect different tax regime structures and this problem seems to have also a spatial character and will pose a serious regional problem for the EU, and especially EMU countries, which already have a common currency and monetary policy.

This research managed to identify a measurement for imbalances. The introduction of the constant variable, common in all EU countries, measured as percentage of GDP embodying a common Tax Collection base, which is the desired outcome in a union of countries. However, this constant term is increased or reduced depending on which country is focused. This is achieved, with the introduction of the dummy variable, which alters the outcome and give us a clear and unambiguous measurement of tax regime diversification per country. A comparative analysis by providing all these measurements for VAT, Personal Tax and Corporate Tax is summarized in the following Figure:



Gathering all the Fixed Effect values estimated for the (3) different taxes, it is noticed that the results do not deviate from the outcomes of the work using multivariate cluster analysis but now a measure for this exists. Countries that face crisis seem to face the largest portion of imbalances. In addition to that, the spatial problem between North and South Europe is obvious, which is mainly caused by the different tax regime of these (2) tiers. Generally, the differences and imbalances between EU countries reflect different national economic legislation and fiscal policies like: imbalances in mobility of productive factors; differentiations in the current account of balance of payments; different levels of expansion in loans and advances or in use of financial or credit products; different deficit and government debt; different unemployment and gross wage revenues per country.

The problem seems to have also a spatial character and will pose a serious regional problem for the EU. The south of Europe is faced with crisis. Policies to reduce the government debt will lead to social discontent, and ultimately the collapse of the European Union. The only policy that seems to be efficient is full integration of the countries with a common fiscal and federal face and legislated solidarity. Nowadays, there are significant differences among the applied tax regimes in EU countries and no policy has been implemented to ensure tax homogeneity across the EU, nor is there any likelihood of such. Even if, EU moves to a common taxation policy, there are obvious indications that it will fail to balance revenues from taxations at the same levels. On the other hand, the 'strong' EU countries, which in reality enforce their own economic policies (mainly designed from their own economic systems), might need to redefine their attitude towards the non-homogeneity of the tax regime in the EU. Countries that are thought to be economic paradises, are actually achieving better results in tax revenue collection. A more loose taxation system might have better results in tax revenue collection.

Special Points of Interest

- A major question emerges regarding the performance of any taxation as a percentage of each country's GDP. Following the outcomes of this study, the taxation imbalances between EU countries can be measured through the use of quantitative tools to analyze collected data from the National Organizations thus giving a clearer and unambiguous measurement of tax regime diversification per EU country as a percentage of each country's GDP.

- Deviations from the rule of proportional change, between tax rate and volume of tax revenues that take into account the common historical performance per tax, indicates: instability in tax performance among countries; the existence of problematic tax legislation in the countries; the tax evasion or failure of tax authorities in collecting taxes or replacement taxable amounts with tax exempt income or with income classified to other tax base with lower tax rate. The proposed practice has obvious practical benefits.

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EMU, Economic Governance and Institutions

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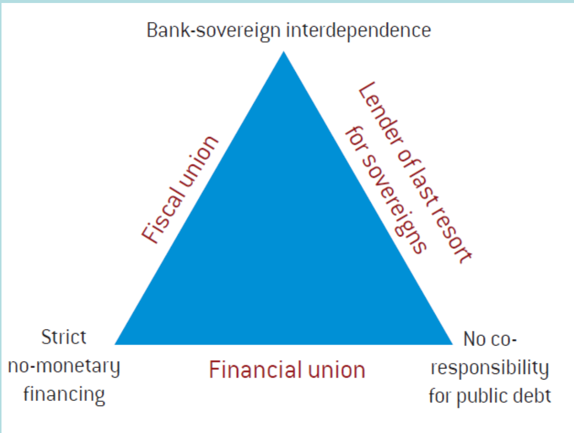
Could the Serbian Banking Sector be Improved by Introducing the Principles and Mechanisms of EMU Banking Union—Professor Oskar Kovac

The Banking Union (BU) is a natural step forward in development of Economic and Monetary Union (EMU). One could argue that the BU is a crucial pillar of EMU alongside Economic Union, Fiscal Union, and Political Union, and that its development, in the eyes of many, was long overdue.

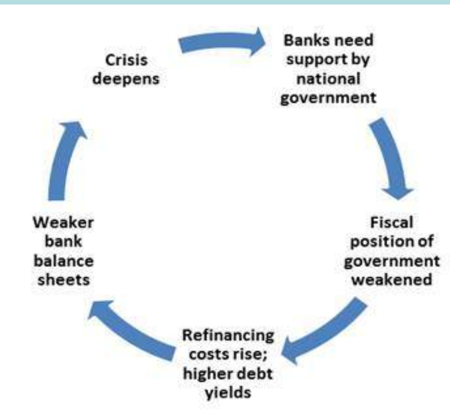
Financial crisis of 2007/2008 came within the EU that had 27 different regulatory systems for banks, no tools to deal with large cross-border banks and a single backstop for banking losses with national budgets. Banks were "European in life and national in death". Entirely national perspective concerning bank regulation, supervision, and resolution were not sufficient for the posed challenge. No Euro zone crises management framework had been put in place to support national resolution capacities. Such a framework was prone to large fiscal burdens on national government levels, and vicious circles between banks and national finances. As an aftermath, it was not a surprise to go through sovereign debt crises within a Euro zone.

Figure 1: Eurozone Structure



The problem of sovereign debt crises in Euro zone was predominantly influenced by bank-sovereign interdependence. However, there are only several possible remedies to this problem. The first is to allow the ECB to lend to sovereigns. This solution is in clear breach of the no-monetary financing of the EU Treaty. The second option is to have co-responsibility for public debt in the Euro zone i.e. a Fiscal union. This solution is not yet politically available. The third remaining option is to have a Financial union, and in the case of Euro zone finance, where the bank credit is a predominant financial instrument, that meant the creation of the Banking union. In other words, it is not possible to have no co-responsibility for public debt, strict no-monetary financing, and no bank-sovereign interdependence. The current Euro zone structure (Figure 1) had to change towards the creation of the BU in order to disentangle the vicious circle of bad bank balance sheets and bad public finance. One can see that this as an available move in a necessary direction, which can be implemented even before the Fiscal union can be constructed in a way that is politically acceptable for all the Euro zone countries.

Despite the fact that BU is a project specifically designed for EMU and EU countries, there are several very important elements of this project that could be important for, and implemented within the countries outside of EU, including Serbia. Whenever you have significant leverage and/or non-performing loans (NPLs) alongside a substantial exposure of banks to sovereigns, economic contraction can produce a negative spiral between worsening bank balance sheets and erosion of national government financial position (Figure 2.). This is reliant on a premise that the central bank is not allowed to finance the government (or provide equity financing for the failing banks) and that the national government is the only backstop for failing systemic banks. Since that is the case in most of the (both EU and non EU countries), lessons from the sovereign debt crises in Europe and the creation of BU, can prove to have valuable guidelines for non EU countries like Serbia.



Special Points of Interest

- The Single Supervisory Mechanism: it will have direct oversight of banks in the euro area and non-euro zone member states that choose to participate.
- The European Central bank will have direct oversight of 130 banks in the euro area or 85% of the whole Banking union of the EU through comprehensive assessment including the asset quality review of those banks and stress test of banks in coordination of the European Banking Authority.
- Future anticipated consequences of the establishment of the Banking union: Mergers, Acquisitions, Closing Down of non-solvent Banks
- ECB Data: the number of banks in the euro zone fell by almost 4% in 2013. There were 6.790 monetary-financial institutions based in the euro area at the start of 2014 compared with 7,069 one year before. More than 3.066 monetary-financial institutions have fallen since 1999 (EURO introduction).
- The Single Resolution Mechanism: aims to ensure the orderly resolution of failing banks without the use of taxpayers' money. This involves a systematic recourse to the bail in of shareholders and creditors, in line with the bank recovery and resolution directive agreed in 12/2013 and the possible recourse to a single fund fully financed by banks.

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EMU, Economic Governance and Institutions

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Could the Serbian Banking Sector be Improved by Introducing the Principles and Mechanisms of EMU Banking Union—Professor Oskar Kovac (cont'd)

The creation of the BU relies on the will to make banks stronger and more immune to shocks. This is a basic principle of creation of a more sound financial system, less prone to be exposed to losses it cannot sustain. This point has a regulatory and a supervisory aspect and both are applicable in Serbia.

First, regulatory aspect relates to implementation of Basel III standards (which are already implemented in the EU through CRD4). Implementation of these standards will provide more quality capital base and liquidity for the banks and insure their strength and immunity to shocks. This is a very important element in providing more loss absorption capacity on the side of the banks, and less risk of additional government expenditures in case of further bank insolvencies. National bank of Serbia (NBS) has implemented Basel II standards in 2011, and plans to implement Basel III standards but not earlier than 2016. Since the banking sector of Serbia is burdened with relatively high levels of NPLs, and since recent bank failures have caused substantial burden for an already fragile fiscal position of the country, it might be wise to conceder earlier adoption of Basel III standards in Serbia. These standards represent a significant portion of the so-called Single rule book of the BU.

Second, supervisory aspect relies on increasing the supervisory capacity of an existing regulator. In case of BU it includes the conduct of screening of the bank balance sheets and implementing stress tests that are realistic for the banks to endure in case of severe financial crises. As in the case of BU, where prior to the ECB engagement as a single supervisor for the whole EMU, thorough screening and stress testing is underway, to expose the strengths and weaknesses of the banking sector, Serbian banking sector should be submitted to the similar process to create a realistic vision of the risks and weaknesses to be addressed preemptively. Therefore, increasing the institutional capacity and realistic fact finding going on in the process of BU creation are needed and desirable in the countries like Serbia as well.

Third, very important aspect of the BU framework is creation of a more effective early intervention system on the side of a supervisor. The same is direly needed in Serbia. Hand in hand with the need to increase the capacity of NBS to detect problems in the banking sector early, the supervisor needs to have powers to react to this findings without delay i.e. long before capital and liquidity parameters are below the required levels, and sometimes, beyond realistic and swift repair. As in the case of BU, these may include demanding recovery plans from the banks, dismissal of the management and appointment of special manager, waiver of distribution of dividends and bonuses, forceful reduction of certain exposures, increase in capital, and mandatory changes to legal or corporate structures of the bank. All of these measures foreseen by the BU to be delegated to the supervisor are eligible to be potentially implemented in Serbia as well.

Finally, BU introduces a very important principal of not allowing tax payers' money to be used to finance bank bailouts. Especially after recent experiences in Serbia, and its fragile fiscal position, this principal deserves to be thoroughly analyzed and implemented as much as possible. The "too big to fail" should be the thing of the past. Alongside stricter regulation, better supervision and preemptive measures, orderly resolution of insolvent banks should be the final important element of the BU principles that could be implemented in Serbia. The clear system of private bail-ins, and bank funded resolution fund is a desperately needed improvement of the banking system, especially for the countries like Serbia, with serious fiscal challenges. For the banks which prove to be unviable, winding down of their operations and orderly resolution without stress implications to the rest of financial system is vital. Some lessons have been learned in Serbia in past couple of years with several bank failures, but there is substantial room to improve the resolution process to be much less expensive for the taxpayers and yet without financial stability consequences.

Special Points of Interest

- The Banking Union has been enacted as a project designed to help overcome the problems of financial crises in the EU, and with a goal to establish a more robust financial system capable of substantially decreasing the risk of future taxpayers' money involvement in banking bailouts.
- However, despite the fact that such a project has been developed to address the specific problems and issues in the Euro zone, it has also developed universal principles and ideas for improvements in national and regional financial system throughout the world.
- Serbia, as a developing nation in South East Europe, has also a number of very useful guidelines and specific measures that can be drawn from the principles and the mechanisms of the EU Banking Union.

The Impact of the Eurozone Crisis on European Banks Stocks - Prof. Jean-Pierre Allegret & Prof. Helene Raymond

The 2007-2009 crisis began by intense tensions in the financial systems of advanced economies and unraveled into a dramatic contraction in global growth. To prevent a larger collapse in economic activity, Governments and central banks intervened massively in order to support aggregate demand – via automatic stabilizers and discretionary expenditures - and to bailout financial institutions. As a result, public finance experienced a marked degradation, leading to the emergence of the eurozone sovereign debt crisis as a new phase of the global crisis.1 According to the IMF Fiscal Monitor, the fiscal deficit in advanced countries moves from 1.3% of the GDP in 2006 to 8.9% in 2009 while the public debt in percentage of the GDP climbed from 75.8 to 93.7 over the same period. The degradation in public finance has been more dramatic in the euro area, and more specifically in its peripheral countries. Thus, the average fiscal deficit in Greece, Ireland, Italy, Portugal, and Spain (GIIPS-group) increased from 1.6% of the GDP in 2006 to 11.2% in 2009, while their public debt surged from 68.4% to 89.6% (with a projected peak at 130.5 percent of the GDP).

Any drop in the market value of European sovereign debt has a negative impact on the balance sheets of European banks. Banks hold large amounts of government bonds to satisfy multiple purposes. First, investing in government bonds allows financial institutions to diversify their portfolio into low risk assets. The European prudential regulation has encouraged banks to hold such safe and liquid securities that may help to cushion losses on riskier assets. Second, holding government bonds is crucial for banks to access the central bank liquidity, insofar as the refinancing operations of the central bank are based on highly rated securities.

The Impact of the Sovereign European Debt Crisis:

During the subprime crisis episode, the sovereign risk indicators do not significantly react. Indeed, neither the term spread – a measure of market expectations about future conditions in the financial markets – nor the sovereign CDS increase in the aftermath of the collapse of the U.S. subprime credit market.

On the contrary, the banking sector experiences visible strains during this first episode of the global financial crisis. Indeed, not only do banks' equity prices decrease , but risk indicators on the interbank markets exhibit signs of stress.

The turning point in the evolution of the global financial has been the collapse of Lehman Brothers on the15th September 2008. Indeed, all risk indicators dramatically increase in the aftermath of this shock. For instance, we observe intense strains on the interbank markets. More importantly for our purpose, the collapse of Lehman Brothers has changed the strategy adopted by authorities to face banking instability.

The Greek sovereign debt crisis that unraveled in 2010 marks a new phase in the development of the global financial crisis. Indeed, the onset of this crisis has increased the implied volatility on the European stock market after a period of relative tranquillity.

According to our analysis, the findings suggest that contagion effects have been limited to European banks and that thedelay in cleaning up European banks' balance sheets of their distressed assets has put them at adisadvantage relatively to their American counterparts. In addition, if we focus more particularly on theimpact of GIP (Greece, Ireland and Portugal) sovereign CDS, we show that contagion effects appearbeyond the banks located in these countries, as banks' equity returns from Belgium, France and Italy have been negatively impacted by the sovereign debt crisis. This result contrast with the one found for U.S. banks, which seem to be unharmed by the direct impact of the European Sovereign debt crisis and even to slightly benefit from the European turmoil through a kind of flight to quality effect.

In terms of policy implications, our results clearly suggest that a resolution of the sovereign debt crisis is a prerequisite to strengthen the stability of the European banking system. From this standpoint, there is a complementarity between the European banking union project and the implementation of mechanisms allowing the resolution of the sovereign debt crisis at the European level. More particularly, our findings echo the studies stressing the structural changes about the public debt management implied by the creation of the monetary union.

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