LISBOA SCHOOL OF ECONOMICS & MANAGEMENT

MASTER

INTERNATIONAL ECONOMICS AND EUROPEAN STUDIES

MASTERS FINAL WORK

DISSERTATION

EFFECTS OF THE BANKING UNION IN THE RISK PERCEPTION OF THE PORTUGUESE ECONOMY

NADINE CRISTINA BASTOS TELES

OCTOBER – 2014

LISBOA SCHOOL OF ECONOMICS & MANAGEMENT

MASTER IN

INTERNATIONAL ECONOMICS AND EUROPEAN STUDIES

MASTERS FINAL WORK

DISSERTATION

EFFECTS OF THE BANKING UNION IN THE RISK PERCEPTION OF THE PORTUGUESE ECONOMY

NADINE CRISTINA BASTOS TELES

SUPERVISOR:

PHD. ANTÓNIO AUGUSTO DA ASCENSÃO MENDONÇA

OCTOBER – 2014

Abstract

This Dissertation aims at understanding what the expected effects of the creation of a Banking Union in the risk perception of the Portuguese economy may be. In other words, in what ways the decision to complete the financial integration of the Economic and Monetary Union by establishing an institutional structure that assures a centralized banking supervision, resolution and deposit guarantee scheme, may prevent the lack of confidence from financial markets to increase the country's risk perception. This study is justified by the fact that the sovereign debt crisis brought up the need to complete Europe's financial integration, since an incomplete Economic and Monetary Union brought forward the negative consequences of the interdependence between sovereign and banking risk in the euro area. In Portugal's case, it is considered that an accumulated debt since 2001 and the bail-out of banks BPN and BPP, together with a spill-over effect from Greece and Ireland, undermined the financial markets' sentiment towards Portugal's ability to finance itself, increasing the country's risk perception of going into default. Through the assessment of recent trends in 10 year Government bond yields and 5 year CDS spreads, it can be concluded that the announcement of a Banking Union in the summer of 2012 seems to have had some positive effects in the risk perception of the Portuguese economy, continued efforts to accelerate the country's process of financial stability are showing results and the instruments already approved within the Banking Union's framework are a step in the right direction.

Keywords: Banking Union; Portuguese sovereign debt; risk perception; Government bond yields; credit default swaps.

Resumo

Esta Dissertação tem como objetivo compreender quais podem ser os efeitos esperados da criação de uma União Bancária na perceção de risco da economia portuguesa. Por outras palavras, de que forma a decisão de completar a integração financeira da União Económica e Monetária através do estabelecimento de uma estrutura institucional que assegura uma supervisão, resolução e um esquema de segurança de depósitos centralizados, pode prevenir a falta de confiança dos mercados financeiros de aumentar a perceção de risco do país. Este estudo é justificado pelo facto de a crise das dívidas soberanas ter revelado a necessidade de se completar a integração financeira da Europa, dado que uma União Económica e Monetária incompleta trouxe ao de cima as consequências negativas da interdependência entre risco soberano e bancário na zona euro. No caso de Portugal, considera-se que uma dívida acumulada desde 2001 e o resgate dos bancos BPN e BPP, juntamente com um efeito de contágio da Grécia e Irlanda, minaram o sentimento dos mercados financeiros relativamente à capacidade de financiamento de Portugal, aumentando a perceção de risco de que o país poderia entrar em incumprimento. Através da avaliação das mais recentes tendências das obrigações da dívida pública a 10 anos e dos *spreads* de CDS a 5 anos, pode concluir-se que o anúncio da União Bancária no verão de 2012 parece ter tido algum efeito positivo na perceção de risco da economia portuguesa, que esforços continuados para acelerar o processo de estabilidade financeira do país estão a mostrar resultados e que os instrumentos no âmbito da União Bancária já aprovados são um passo na direção certa.

Palavras-chave: União Bancária; dívida soberana portuguesa; perceção de risco; obrigações de dívida pública; credit default swaps.

Acknowledgements

As a Social Sciences' student that decided to adventure in the world of Economics, I have a lot of people to thank for the encouragement, the support and the motivation given throughout these two years. Without all of them, the goals I set to achieve for myself would have definitely been much more difficult to accomplish.

First of all, I would like to thank to my supervisor Prof. António Mendonça for all the guidance and confidence he gave me throughout the last few months. It truly is difficult to undertake such a project without someone who beliefs in you and in all the work and dedication you have put into writing your Dissertation.

My greatest gratitude goes, however, to my family – papá, mamã, Alina, vovó, vovô, tiá and tió – who have always been there for me no matter what since the beginning of my academic journey and have always said there was nothing I wasn't able to achieve without a lot of work, commitment and dedication. To them, I give all my love and hope this Dissertation may be a way of thanking them for all their support.

I would also like to thank to all the people from the Representation of the European Commission in Portugal and especially to Katalin Gonczy for all the support and motivation given during the writing of my Dissertation and mainly for giving me the best 1st job experience I could have ever asked for. To them and to her, my sincere gratitude.

Last but not least, to all my childhood and college friends, to all the others I have made along the way and to my remaining family a most sincere thank you for being there for me when I needed and for motivating me to continue on this academic journey. I will never forget all of your support and friendship and I will always carry you in my heart. You are, after all, the people of "my life".

Table of Contents

List of Acronyms

ABRRD	Agreement on Bank Recovery and Resolution Directive
BCP	Banco Comercial Português
BES	Banco Espírito Santo
BPI	Banco Português de Investimento
BPN	Banco Português de Negócios
BPP	Banco Privado Português
CDS	Credit Default Swap
CDU	Christian Democratic Union
CGD	Caixa Geral de Depósitos
CRDIV	Capital Requirements Directive IV
DDGS	Directive on Deposit Guarantee Scheme
DGS	Deposit Guarantee Scheme
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
EMU	Economic and Monetary Union
EP	European Parliament
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
GDP	Gross Domestic Product
GES	Grupo Espírito Santo
NSI	National Statistics Institute
OMT	Outright Monetary Transactions
SGP	Stability and Growth Pact
SPD	Social Democratic Party
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism

Introduction

This Dissertation aims at understanding what the expected effects of the creation of a Banking Union in the risk perception of the Portuguese economy may be. In other words, in what ways the decision to complete the financial integration of the EMU by establishing an institutional structure that assures, at a European level, a centralized banking supervision, resolution and DGS, may prevent the lack of confidence from financial markets to increase the country's risk perception.

This study is justified by the fact that the sovereign debt crisis brought up the need to complete Europe's financial integration since highly indebted countries within the euro area were confronted with the negative perception from financial markets on the repayment of their sovereign debts. The sovereign debt crisis also brought forward the negative consequences of the interdependence between sovereign and banking risk in the euro area due to an incomplete financial integration of the EMU. In fact, without a true financial integration, banking systems were still largely national and, therefore, States were individually responsible for rescuing their national banks.

As a result, the creation of a Banking Union started to be seen as a necessary step to complete the EMU's successive structural reforms in the financial sector. The main goal was to reduce the almost automatic link that financial markets establish between the financial situation of a State and its national banks. Although this project has experienced some resistance from several Member-States during its negotiation process, small but significant steps have been made towards deciding on its 3 main instruments: a SSM, a SRM and a DGS. By agreeing on these instruments, with national banks being coordinated at a European level and not so closely tied to sovereigns, Member-States expected a more financially stable euro area.

In order to evaluate if the idea of creating a Banking Union had a positive or a negative effect in the risk perception of the Portuguese economy after its announcement in the summer of 2012, 2 main financial instruments that measure the countries' default risk were used: (1) 10 year Government bond yields, between 2001 to 2013 and (2) 5 year CDS spreads, between 2008 and 2013. The time period chosen follows the years prior to the sovereign debt crisis – after Portugal adopted the single currency – and until the most recent data available. Due to a lack of earlier data available in the Bloomberg database, 5 year CDS spreads are only measured between 2004 and 2013. 5 year and 10 year maturities were chosen in order to have a medium and a long-term assessment of the country's risk perception. Both indicators are also compared with the German benchmark in order to understand the significant differences in the risk perception.

In Portugal's case, it is considered that an accumulated debt since 2001 and the bail-out of national banks BPN and BPP, together with a spill-over effect from Greece and Ireland, undermined the financial market's sentiment towards the country's ability to finance itself, increasing Portugal's risk perception of going into default.

Therefore, this Dissertation is organized in 4 sections: (1) chapter 1 tries to understand why the call for a Banking Union was only made after the sovereign debt crisis; (2) chapter 2 evaluates all the steps done so far towards a Banking Union, taking into account the political debate in every step of its negotiation process and in which way it affected the end result; (3) chapter 3 describes the interdependence channels between States and banks, according to the studies available; (4) chapter 4 assesses the expected effects of the Banking Union in the risk perception of the Portuguese economy, through an analysis of the country's 10 year Government bond yields and 5 year CDS spreads between 2001 and 2013.

1. The post-sovereign debt crisis call for a Banking Union

1.1. Introduction

The following chapter tries to understand why the call for a Banking Union was only made after the sovereign debt crisis, through and analysis of the most important financial events since the creation of the EMU. The chapter's main goals are to explain how an incomplete EMU led to different risk perceptions of the euro area countries' debts and how a Banking Union was never perceived as a need by policymakers.

1.2. The aftermath of the sovereign debt crisis

The world financial crisis of 2007-2008, which spread to Europe and originated what became known as the sovereign debt crisis, was preceded by a particularly favourable period of abundant liquidity, with large capital flows and low interest rates in Europe, which facilitated the accumulation of sovereign and private sector deficits (Angeloni *et al*, 2012; Goyal *et al*, 2013).

For the euro area countries, this period of easy access to credit and market stability started with the EMU's creation in 1999. Since then, a single currency and the coordination of economic policies in the monetary and fiscal/budget areas were adopted by Member-States that wanted to become part of the euro area (see Caetano & Sousa, 2012). However, apart from the need for a strong supervision of those countries' public finances, easier access to bank credit strongly facilitated their increase of public consumption and public spending, a phenomenon of lack of fiscal/budget discipline that represented over a decade of accumulated public debt and compromised the credibility of the euro area fiscal/budget rules (Angeloni *et al*, 2012; Pisani-Ferry, 2012).

As Figure I shows, for almost 10 years financial markets did not differentiate the euro area sovereign risks, with Government bond yields being considered risk free and, therefore, treated similarly (also see Pisani-Ferry, 2012).

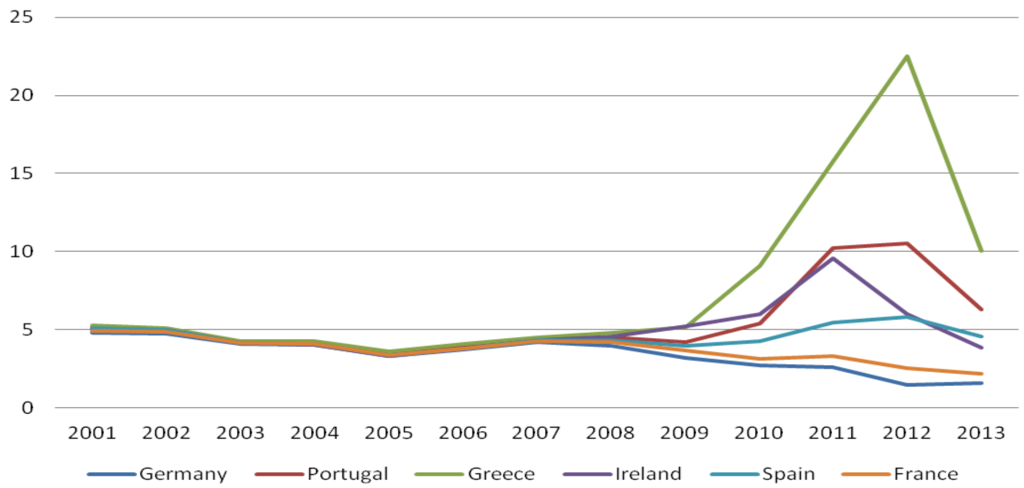


Figure I – Long-Term Government Bond Yields - 10 Year Maturity (%), annual data

Source: Author's elaboration on Eurostat and OECD data

However, the stability of the single currency became compromised when 3 north-American credit rating agencies - Standar&Poor's, Moody's and Fitch - downgraded Greece's sovereign debt rate in 2010, associating it with a higher risk of the country not being able to repay its sovereign debt to international creditors. In that year, Greece's 10 year Government bond yields rose to 9.09%, a record value since 2001 (see Figure I). Eventually, Greece's rating downgrade had a spill-over effect to other also highly indebted euro area countries such as Portugal, Ireland and Spain. Afterwards, those countries' sovereign spreads rose sharply and the resulting rating downgrade of their sovereign debt rates by the same 3 agencies gave international creditors the idea that they also had a higher risk of default.

This negative perception in the financial markets led to different borrowing costs for sovereigns and national private sectors within the euro area (Angeloni *et al*, 2012;

De Santis, 2012; Goyal *et al*, 2013). In other words, and as it can be seen in Figure I, instability in the financial markets led to a massive deterioration of the most vulnerable euro area countries' public finances after 2009, leading to higher Government bond yields – meaning different borrowing costs – in Portugal, Ireland, Greece and Spain in comparison with the downward trend of German and French bonds. For example, Portugal's 10 year Government bond yields had a sudden rise in 2011 to 10.24%, in comparison with the 5.4% recorded in 2010. In contrast, Germany's 10 year Government bond yields decreased from 2.74% in 2010 to 2.61% in 2011.

For the EU, the sovereign debt crisis was a warning for the need to improve the EMU's still incomplete institutional architecture and decide on comprehensive structural reforms to solve the crisis and prevent future ones, this way safeguarding the stability of the euro area and of the single currency.

In the beginning of the debate on how to respond to the crisis, the EU took a more Keynesian interventionist position, more concerned with the necessary stimulus to boost Europe's economic growth and job creation. The EC's communication "A European Economic Recovery Plan" of November 2008 (see Commission of the European Communities, 2008) presented as key pillars a budgetary impulse of 200 billion euros – 1.5% of GDP – to boost demand and the bet on short-term direct policies to support the economy. However, by the end of 2009 this position was overtaken by the ongoing concern with the highly indebted euro area countries and EU's response to tackle the crisis suffered a turning point (see Council of the European Union, 2009; European Council, 2009; 2010), with a concentration of efforts on the need to return to a sustainable fiscal position and the bet on fiscal/budget consolidation strategies for Member-States. This new position was, as a result, more focused on the priority of budget deficit and public debt reduction within the framework of the SGP, although combined with structural reforms to support economic growth and job creation. In the end, the goal was to complete the institutional architecture of the EMU, considered one of the core problems of its Member-States imbalanced public finances (see Caetano & Sousa, 2012; 2013; Ferreira & Caetano, 2013; Goyal *et al*, 2013; Pisani-Ferry, 2012).

Although initially created to prevent excessive fiscal/budget deficits and public debts, 10 years after its creation, the EMU was still unable to effectively coordinate the euro area countries' fiscal/budget policy, fuelling heterogeneity between their public finances and increasing divergence between their economic cycles. Therefore, given the different paths of economic development among euro area countries, when the world financial crisis hit Europe in 2009, the euro area suffered asymmetrical chocks and was confronted with a still incomplete architecture unable to efficiently tackle the crisis.

Existing fiscal/budget deficits in its more vulnerable countries were, as a result, exacerbated by the recession that hit Europe, bringing public debt to critical levels in Greece, Portugal, Ireland and Spain. Also adding to their accumulated public debt were several public bail-outs to national banks, with States increasing their public expenditure to prevent banks from failing and simultaneously trying to avoid the collapse of their banking systems. In fact, with banking systems still largely national – meaning that States were individually responsible for rescuing their national banks –, the most vulnerable euro area countries became highly exposed to the cost of their national banking crises. For example, after the Irish Government decided to extend its public debt by taking over enormous liabilities from national bad banks, Ireland's 10 year Government bonds yields rose sharply from 5.76% in the 3rd quarter of 2010 to

8.41% in the 4th quarter of 2010 and, in November 2010, Ireland asked for international financial assistance[1].

Ultimately, the lack of confidence from financial markets was fuelled by an incomplete EMU and the challenges it could pose on its most vulnerable countries during the crisis. According to Caetano & Sousa (2012), some existing legal constraints, such as the "no bail-out" clause - stating that the EU and/or its Member-States are not responsible for other Member-States financial commitments - and the ECB’s prohibition to directly fund a financially needing country, characterised the euro area’s lack of formal lender of last resort in order to deal with the countries’ liquidity problems. There were also missing from the EMU’s institutional architecture effective economic surveillance and coordination tools to keep on track the countries’ public finances and an integrated financial framework for supervision, resolution and deposit guarantee for banks to end with the vicious cycle between banking and sovereign debt. As a result, some authors claim that the EMU was a political rather than an economic construction (see De Grauwe, 2013; Schiliro, 2014).

Shut out from financial markets and unable to access liquidity in order to repay their accumulated public debts and with a simultaneous lack of an effective EU euro-specific crisis resolution oriented approach, Portugal, Ireland and Greece's Government bonds rose sharply, mirroring the increasing risk perception of their sovereign (and banking) debt (see Figure I). As a result, they had no other option than to implement national Financial Adjustment Programmes to meet their refinancing needs and reach for balanced public finances and the sustainability of their national banking sectors[2].

[1] See Annex I.
[2] Spain only needed assistance for its banking system.

1.3. Why the need for a Banking Union?

The main reason why the call for a Banking Union was only made by the EU after the sovereign debt crisis is because European integration has always been made as challenges appear and when its policymakers realise that the current functioning of EU's institutions is unable to reach for a short-term solution and/or a long-term result to tackle the crisis Europe may be facing at that particular time. As a result, for the EU the sovereign debt crisis meant understanding that the EMU was malfunctioning ever since it entered into force (Caetano & Sousa, 2012; De Grauwe, 2013; Ferreira & Caetano, 2013; Goyal *et al*, 2013; Pisani-Ferry, 2012; Schiliro, 2014).

Therefore, the idea of a full and comprehensive Banking Union is the last stage of EU's successive structural reforms in the financial sector in order to complete the EMU. This means that Europe's further financial integration has been made step by step since the EMU's creation and only when Member-States learn from the hard lessons of a crisis and realise that efforts must be made to prevent Europe from going back to a more incomplete and, thus, unstable stage of its architectural institutional development.

In fact, since the beginning of Europe's integration, the idea of a Banking Union as final step for a complete financial integration of the EU was never perceived as a need until the sovereign debt crisis, in spite the warnings made (see Alesina & Gilli, 1991; Folkerts-Landau & Garber, 1992). Since Member-States were never faced with the particular situation of credit constraint in the financial markets and simultaneous high public debt – in some cases, related with public bail-outs of national banks in risk of failure –, policymakers never became aware of the negative consequences an incomplete financial integration would pose for the most vulnerable countries of the euro area or even the possibility of contagion to other more economically robust members and, therefore, agreed to maintain most financial decisions at a national level. For this reason, according to Pisani-Ferry & Wolff (2012) and Ferreira & Caetano (2013), the sovereign debt crisis revealed that under financial stress, participation in the EMU exacerbated existing weaknesses on fiscal/budget and financial stability, so the call for a Banking Union started to be seen as a necessary step towards Europe’s recovery from the crisis and the EMU’s own survival.

Thus, with steps towards a Banking Union, policymakers expected a decrease in the risk perception of the sovereign debt of the most vulnerable countries of the euro area and, ultimately, the euro area’s overall return to financial stability, since the strong interdependence between States and their banking systems would have been broken, or at least minimized. According to Pisani-Ferry & Wolff (2012), a Banking Union started to be considered as being able to contribute to reduce the almost automatic link that financial markets, especially credit rating agencies, established between the financial situation of a State and its national banks, this way reducing the frequency of banking and sovereign debt crisis.

However, even before clear steps towards a Banking Union were given, and despite the broad consensus on its advantages for the EU, the challenges it theoretically poses have been subject of a sound debate ever since. For some, for example, the debate is focused on the consideration that the legal method chosen by the EC to implement the Banking Union is fatally flawed (see Davies, 2012; Huertas, 2012; Caetano & Sousa, 2013). For others, the discussion concerns more technical aspects, related with the modalities of its main instruments – especially the debate on the exact role of the ECB and the importance of having a DGS –, the complexities of implementing a Banking Union in a relatively short period of time and the call to take on a broader view and contemplate other reforms than only in the financial sector (see Foarta, 2014; Goyal *et al*, 2012; Gros, 2013; Pisani-Ferry, 2012; Pisani-Ferry & Wolff, 2012).

1.4. Final remarks

It can be concluded that the call for a Banking Union was only made after the sovereign debt crisis because since the EMU's creation Member-States had never been confronted with the particular situation of credit constraint in the financial markets vis-à-vis high public debt. Hence, policymakers decided for an incomplete financial integration unaware of the negative consequences it would pose and, thus, a Banking Union was never seen as a priority. The downgrade of Greece's sovereign debt rate was a wakeup call for the EU that the assessment of financial markets of the euro area countries had changed and the events that followed – negative risk perception of other countries' sovereign debts – led to the need to further integrate the financial system and, as a result, steps towards a Banking Union began to be made.

2. Steps towards a Banking Union

2.1. Introduction

The following chapter describes all the steps done so far in the creation of a Banking Union in order to complete the EMU, taking into account the order in which its instruments were decided and implemented. It also considers the political debate among Member-States in every decision making and tries to evaluate how resistance from some specific Member-States to the original framework affected the negotiation process and the Banking Union's end results.

2.2. More robust regulation and supervision of the European financial sector

Until 2009, the EU had 27 different regulatory systems for banks, largely based on national rules and national rescue measures, although with some minimum European rules (European Commission, 2014b). Therefore, the former architecture of the EU was largely based on national supervision, resolution and deposit guarantee schemes.

The deepening of the sovereign debt crisis highlighted the need for more robust regulation and supervision of the EU's financial sector due to the awareness of the EMU's inability to tackle its negative consequences in the most vulnerable countries of the euro area. As a result, European policymakers soon decided to take on measures to secure a better integration of the European financial sector, since uncoordinated national responses to the failure of banks led to higher sovereign debts, different borrowing costs and the fragmentation of the financial markets (see Angeloni *et al*, 2012; Goyal *et al*, 2012).

According to official documents from the EC (see European Commission, 2014b), regarding supervision, in January 2011, 3 European supervisory authorities were created: the EBA, by far the most important, the ESMA and the EIOPA. It was also created an ESRB. On the other hand, in terms of regulation, the European Council of June 2009 recommended the establishment of a single rulebook, covering all the financial institutions of the EU through 3 main legislative packages: the CRDIV - commonly known as the Basel III agreement -, the DDGS and the ABRRD.

Table I shows the main functions of each supervisory and regulatory instrument created under the framework of the structural reform of the European financial sector.

Table I

Main functions of the supervisory and regulatory instruments of EU’s financial reform

Supervision	**Supervisory Authorities**	**EBA**		Deals with bank supervision, which also includes the supervision of the recapitalization of banks.
		ESMA		Deals with the supervision of capital markets and carries out direct supervision to credit rating agencies and trade repositories.
		EIOPA		Deals with insurance supervision.
	ESRB			Monitors and assesses potential threats to financial stability.
Regulation	**Single Rulebook**	**Legislative packages**	**CRDIV**	Requires banks to keep sufficient capital reserves and liquidity in order to manage the risk linked to their activities without the need of support from national authorities.
			DDGS	Ensures that bank deposits in all Member-States will continue to be guaranteed up to € 100 000 per depositor if a bank fails, this way preventing depositors from making excessive withdrawals from their banks.
			ABRRD	Assures a bail-in mechanism through which shareholders and creditors of the banks will have to pay their share of the costs, meaning that the burden of a bank failure is not imposed on taxpayers through the bail-out by public funds.

Source: Author's elaboration on European Commission (2014b) data

2.3. The initial call for a Banking Union and the Four President’s Report

Notwithstanding ongoing financial reforms, policymakers became aware that a more robust European financial sector was not enough for the vicious cycle between States and banks to be broken, in particular in countries’ that shared a single currency.

The first decisive call for a Banking Union was made by the EC in May 2012 in its “Communication on action for stability, growth and jobs”, stating that Europe should move towards a more integrated financial supervision as first step for a Banking Union, in order to restore confidence in the euro area countries (European Commission, 2012a).

Afterwards, the European Council of June 2012 put forward the Report "Towards a genuine Economic and Monetary Union", in which advised the establishment of a Banking Union and decided on the implementation of a single supervisor for all euro banks (Van Rompuy, 2012). A few days later, in the euro area summit of June 29, the euro area heads of State and Government established a SSM for banks and assigned specific supervisory tasks to the ECB. On September 2012, the EC formulated the Communication "A Roadmap towards a Banking Union", with the aim of setting up the SSM, align the already existing EBA role and responsibilities with the new framework for banking supervision and establish the next steps in the resolution of banking crises (European Commission, 2012b).

However, the decisive moment in the debate on the creation of a Banking Union came in 5 December 2012, with the release of the Four President´s Report "Towards a genuine Economic and Monetary Union", since the creation of such institutional structure was finally validated by the four main EU institutions – the European Council, the EC, the Eurogroup and the ECB. According to the Report (see Van Rompuy *et al*, 2012), a full and comprehensive EMU should be based on 3 types of integration - financial, budgetary and economic – and provide political accountability. It also foreseen that the process of completing the EMU should be made step by step and, thus, divided into 3 stages of process[3]. The Report was also very important to understand how the Banking Union was going to function.

It was established that the foundation for the Banking Union was the creation of an institutional structure that assured, at a European level, 3 specific elements: (1) a SSM responsible for common banking supervision and regulation in order to increase

[3] See Annex II.

the safety of banks; (2) a SRM for troubled banks facing liquidity and/or solvency problems, with the financial backstop of a SRF; and (3) a DGS that ensures an appropriate degree of protection for depositors and prevents deposit flights.

Together, they form a full and comprehensive Banking Union and, by agreeing on these instruments, Member-States were trying to coordinate their national banking systems to prevent the lack of confidence from financial markets to increase the risk perception of their sovereign debts, which negatively affected the countries and their banks liquidity levels. This means that the interaction of troubled banks and sovereigns made it clear for policymakers that the euro area would be more financially stable if national banks were coordinated at a European level and not so closely tied to sovereigns. Since then, the elements of the Banking Union have been decided step by step and the decisions made on how and when they are implemented have been the result of long-term conversations between all 28 EU Member-States.

However, regardless the need for more financial integration, some countries showed sound resistance and hesitation towards the Banking Union project and, thus, steps have slowly been taken given the lack of consensus between all Member-States. According to Ferreira & Caetano (2013) and Goyal *et al* (2012), in the beginning of the debate on the creation of a Banking Union, and in spite knowing that it was a necessary step for the euro, Member-States that did not share the euro questioned the project and presented a lot of reservations to the framework of the Banking Union. For example, according to Howard Davies (2012), during the initial debate on what was going to be the ECB's role within the Banking Union, the United Kingdom and Sweden argued that they could not accept the ECB as single supervisor since they were semi-detached members of the EU and non-members of the euro area. Thus, it was considered prudent by policymakers to first proceed with a Banking Union only for the euro area, although with the option to opt in for non-euro area countries and with adequate safeguards for those which wanted to stay out, which is currently the ongoing scheme.

2.4. The Single Supervisory Mechanism

In March 2013, the European Council, the EC and the EP reached an agreement on the creation of a SSM for the euro area, the first and the most important element of the Banking Union. According to the Council Regulation nº1024/2013 of 15 October 2013 (see Council of the European Union, 2013a), the regulation on the SSM entered into force in 3 November 2013, although with the ECB only assuming its full supervisory tasks in 4 November 2014, 12 months after the regulation enters into force.

According to official documents from the EC (see European Commission, 2013, 2014b) and the Council of the EU (see Council of the European Union, 2013a), under the SSM, banks are regulated and supervised taking into consideration the following framework: (1) the ECB is the ultimate supervisor of all banks in the euro area, ensuring the application of the single rulebook, and carries out its tasks with the help of national competent authorities; (2) the ECB directly supervises systemically relevant banks - including banks that have assets of more than 30 billion euros or constituting at least 20% of their home GDP - and banks receiving public support; (3) the ECB also monitors the supervision exerted by national supervisors on less significant banks and may decide to directly supervise one or more of these; and (4) the EBA will continue to enforce the single rulebook to all Member-States but must align its role and responsibilities with the new framework for banking supervision.

However, according to Howard Davies (2012), the negotiation of the SSM took much longer than expected due to some resistance, mainly from Germany. In order to preserve the influence of national authorities on its regional banks, the smaller *landesbanks* (state-owned regional banks) and the *sparkaseen* (smaller savings banks), Germany asked for the main focus of the single supervisor to be only on large systemic banks, since they continue to play an important role as low cost deposit taking and lending to local companies. For Wilson *et al* (2012) and Steinhauser & Stevens (2013), Germany’s main argument against an ECB's larger supervisory scope was that home regulators better understand the smaller regional banks’ characteristics and way of doing business and an ECB's supervision would be unnecessary on banks that pose no systemic danger to the euro area.

2.5. The Single Resolution Mechanism

In order to complete the SSM and make sure that if a bank fails who carries out the burden of losses are the banks themselves – shareholders and creditors - and not taxpayers through public bail-outs, the EC then proposed the agreement on a SRM in July 2013, with the aim of ensuring a more efficient resolution by the ECB of a bank subject to the SSM that may face serious liquidity and/or solvency problems. In March 2014, the EP and the European Council reached an agreement on the SRM implementation, which enters into force in January 2015, whereas bail-in and resolution functions would apply from January 2016 (see Council of the European Union, 2013b; European Commission, 2014a). In 21 May 2014, Member-States signed the agreement that will create the SRF.

Through the concrete implementation of the ABRRD in euro area countries, the SRM will be applicable to all banks under the SSM and will take over if the ECB, as banking supervisor, flags a bank as needing to be financially assisted. Especially in cases of cross-border bank failure, the SRM is expected to be much more effective than a network of national resolution authorities, since it establishes a SRF as a common backstop for systemic situations, with a target level of 55 billion euros, to which all the banks in the participating Member-States must contribute through *ex ante* risk levies, this way replacing national resolution funds and guaranteeing Member-States budgetary sovereignty - since it prohibits State aid without prior approval of the ECB (see Council of the European Union, 2013b; European Commission, 2013, 2014a, 2014b).

In the euro area summit of 29 June 2012, it was proposed that the ESM should become available to directly recapitalise imbalanced banks, once an effective supervisory mechanism involving the ECB was established for banks in the euro area, this way serving as a backstop to the SRF, with a maximum amount of 60 billion euros. This proposal was mainly supported by France and the EP. However, some reservations regarding the ESM direct recapitalisation were raised by Germany that did not want to pay for other countries' bank problems and was against losing its national sovereignty on bank recapitalisation. Although Angela Merkel, chancellor of Germany, agreed in June 2012 with the possibility of direct recapitalisation from the ESM, the negotiations on the SRM occurred at the same time as Germany's national elections in September 2013, in which the chancellor's party, CDU, was unable to have the majority of the votes and, thus, started negotiations with the SPD party in October 2013 in order to form a coalition Government. This process delayed the SRM negotiations since the SPD was clearly against a direct recapitalisation from the ESM – which ended up being

Germany's final decision on the matter - and Germany's position was crucial to decide on the SRM's final framework.

Moreover, due to Germany's resistance on paying for other countries' bank problems, the SRM will only be truly common after 2024. Since the country has the largest and the most well financed Resolution Fund, according to official documents from the EC (see European Commission, 2014a), there will be a transitional period of 8 years in which all banks from each country will have to gradually contribute for the 55 billion euros to the SRF. The new mechanism will be able to create a credit line that allows for the ECB to intervene since the beginning, even before the Fund is completed, although the almost automatic link between sovereigns and banks financial situation will remain. The accumulated contributions may be progressively mutualised during those 8 years and the transfer of national compartments would be provided through an inter-governmental agreement, as Germany asked. Thus, by the end of the 1st year, 40% of the common fund will be available and, by the end of 3 years, 70% of it will be available for the ECB to engage on bank rescues. This decision goes against the EP and France's struggle of a truly European fund for troubled banks.

The negotiation on the SRM decision process was also subject of divergences between the EP and France, on the one hand, and Germany, on the other hand. For the first two, the EC should be the institution to trigger the process of a bank's resolution flagged as being at risk by the ECB, always taking into account the plans agreed by a council of resolution - formed by the national authorities of the country whose bank is at risk. On the contrary, Germany wanted to limit the EC's power and give the final word to the EU Council. However, contrary to other negotiations on the SRM framework – the ESM's direct recapitalization and the SRF -, the EP decided to take on a particularly strong position against Germany and maintain the decision on the resolution process of a bank on the EC.

2.6. The current situation and what remains to be done

The ECB is currently carrying out a comprehensive assessment of the 128 banks considered systemic – through stress tests and the evaluation of the quality of their financial assets –, which will be under its direct supervision, with the help of the EBA. The results will be released on the 2nd half of October 2014 and, starting November 2014, the ECB will be fully operational and able to start exercising its full supervision power and tasks in the 6000 European banks from the participating Member-States.

In spite the many advances towards reforms on the European financial sector and, ultimately, towards a Banking Union, its 3rd pillar, a supranational DGS is not yet foreseen to be put forward by the EC (European Commission, 2014b). According to official documents from the EU (Van Rompuy *et al*, 2012), this mechanism would have allowed for the harmonization of national DGS, thereby limiting the spill-over effects associated with deposit flights between banks within and across Member-States. Meanwhile, the DDGS already put forward is the only form of protection of deposits foreseen at this stage. EC's President José Manuel Barroso already stated that with the SSM and the SRM the Banking Union is complete (see European Commission, 2014a).

The fact that there is still too much to do to complete the European Banking Union shows that it is much easier to endorse its concept than it is to design and implement it, since Member-States have divergent interests and experience different economic and financial realities (Elliot, 2012). According to Alex Barker (2014), the Banking Union is still an imperfect construction since out of its 3 pillars, only one – the

SSM - is complete (see point 2.4). On the contrary, the SRM is still halfway (see point 2.5) and the DGS has not yet been considered to be implemented. However, with the willingness of Member-States, especially the most affected by the sovereign debt crisis, and in spite some constraints imposed along the negotiation process, many advances have been made towards a more financially integrated EMU.

Table II shows the advances already made, what remains to be done in order to complete the Banking Union and the measures that have been left behind as a result of the negotiation process of each pillar.

Table II

Comparison between the concept of a Banking Union and its concrete implementation

	Initial goal	What has been done	What will happen	What has been dropped
SSM	Responsible for common banking supervision and regulation in order to increase the safety of banks	**March 2013:** agreement on the SSM creation **November 2013:** SSM regulation enters into force	**October 2014:** end of the ECB's stress tests **November 2014:** the ECB will assume full supervisory tasks	The ECB's supervision of all European banks (only systemic relevant banks will be under its supervision)
SRM	Responsible for troubled banks facing liquidity and/or solvency problems with the financial backstop of a SRF	**March 2014:** agreement on the SRM creation **May 2014:** agreement on the SRF creation	**January 2015:** the SRM will enter into force **January 2016:** bail-in and resolution functions start to be applicable **Starting 2024:** a truly common SRM enters into force (with a SRF)	ESM direct recapitalization of imbalanced banks Creation of a SRF at the same time the SRM would have come into force (transitional period of 8 years with gradual contributions)
DGS	Responsible for ensuring an appropriate degree of protection for depositors and prevent deposit flights	Not foreseen		

Source: Author's elaboration

2.7. Final remarks

It can be concluded that there is still too much to do in order to complete the Banking Union's current framework. Divergent interests among Member-States have undermined the negotiation process in each step, although it is clear that important steps have been made to further Europe's financial integration and try to break, or at least minimize, the vicious cycle of risk sharing between States and banks. By coordinating at a European level and not so closely tied to sovereigns what was until 2012 a national supervision, resolution and deposit guarantee scheme, policymakers are trying to turn the euro area financially stable again as it was before the sovereign debt crisis.

3. Banking and Sovereign interdependence in an incomplete EMU

3.1. Introduction

The following chapter describes the interdependence channels between States and their national banks, according to the studies available, in order to understand why this link has a negative effect in an incomplete EMU. The concept of "risk" and the financial instruments most used to assess its respective value – CDS spreads and Government bond yields – are also taken into account as to understand the financial risk involved in the dynamics between States and banks in the euro area.

3.2. Banking and Sovereign risk transmition in the EMU

A Banking Union for Europe, considered by many as the last stage of a deeper financial integration of the EMU, aims at breaking or, at least, minimizing the complex dynamics of the risk transmition between States (public sector) and their national banks (private sector). Therefore, the main goal of the Banking Union is for banking crisis not to be linked with sovereign debt crisis.

A risk is associated with the possibility of a debt issuer default on payments[4]. Therefore, a sovereign risk is the risk that a Government could default on its debt – sovereign debt – or other obligations, generally associated with investing in a particular country or providing funds to its Government[5], while a bank risk regards the probability of a bank default on its debt.

The main financial instrument used to assess a default risk and its respective value is the CDS. According to Alter & Schuler (2011), a CDS is a bilateral agreement that transfers the credit risk of a reference entity – corporation, sovereign, index, basket of assets –, which pays a periodic fee, to a credit risk taker, which in turn is compensated in case of default of the underlying entity, with a payoff (also see Dias & Abreu, 2012). Therefore, a CDS can be seen as the price of the credit risk undertaken and the CDS spread represents the insurance premium paid.

A country's risk perception can also be assessed through Government (sovereign) bond yields, which reflects the price the country has to pay for the credit received – which equals its interest rate. Sovereign bonds and sovereign debt can be used interchangeably, although sovereign debt can also refer to the total outstanding stock of a country's Government debt[6]. However, although in theory sovereign debt is considered to be risk free, as the Government can employ different measures to guarantee repayment, in practice, there have been multiple cases in which Governments could not serve their debt obligations, such as happened during the sovereign debt crisis, and had to default. As a consequence, investors ask for different yields across countries,

[4] Available at: http://lexicon.ft.com/Term?term=credit-risk [Accessed on: 2014/06/11].
[5] Available at: http://lexicon.ft.com/Term?term=sovereign-risk [Accessed on: 2014/06/11].
[6] Available at: http://lexicon.ft.com/Term?term=sovereign-bonds [Accessed on: 2014/07/21].

which measure the bondholder's total return. Therefore, the more a country's repayment ability is in question and the riskier sovereign debt becomes, the higher is its yield[7].

Thus, through a Banking Union, the EU and the single currency are not put at risk by failing banks – with liquidity and/or solvency problems - and, on the contrary, national or cross-country banks are not put at risk by States – with unbalanced public finances. This is of paramount importance, especially to the most vulnerable countries of the euro area, since the macroeconomic consequences of this vicious link are fewer bank loans to the real economy - companies and households.

Therefore, since the beginning of the sovereign debt crisis, various studies have analysed the spill over effects from banks to sovereigns, modelling the link between bank bail-outs and sovereign credit risk (for example, Acharya *et al*, 2011; Alter & Schuler, 2011; Gerlach *et* al, 2010), while others have focused on the impact of sovereign risk on banking risk within the euro area (for example, Merler & Pisani-Ferry, 2012), since the interdependence between a country and its national banks is very high, especially in the EMU where countries are more sensitive to the health of their finances.

According to a study made by Angeloni *et al* (2012) on the correlation between sovereign and banking CDS on the peripherical countries of the euro area[8], although the interdependence between States and banks is not specific of the euro area countries, this relation is exacerbated due to the EMU's existing weakness of having an incomplete economic and financial integration. The study results showed that, for countries in the euro area, higher bank CDS prices were associated with higher sovereign risk. Therefore, the reason why sovereign and banking risk seem to be indissolubly tied in the euro area is twofold: on the one hand, through public funds, States have to

[7] Available at: http://lexicon.ft.com/Term?term=sovereign-debt [Accessed on: 2014/07/21].
[8] According to the study, the correlation between sovereign and banking CDS was of 67.5% in Ireland, 96.8% in Italy, 80.6% in Portugal and 88% in Spain.

individually guarantee the bail-out of their national banks if these are at risk of failure, since the ECB is not allowed to directly fund banks with financing needs due to the lack of an integrated supervisory and resolution authority (as in the Irish and Spanish cases); on the other hand, since they have a considerable share of public debt in their balance sheets, in comparison with banks in other countries, national banks in the euro area are negatively affected whenever there is a decline in the confidence levels on the State's sovereign debt (as in the Greek case). The same reasons are also put forward by other studies such as Acharya *et al* (2011), Alter & Schuler (2011), Gerlach *et al* (2010), and Merler & Pisani-Ferry (2012).

Therefore, it is considered that the world financial crisis led to a new evaluation of the default risk of sovereigns and banks. For Pisani-Ferry (2012), financial markets began to understand that such a vicious cycle made public finances in the euro area more vulnerable to liquidity crisis and decided to price sovereign risk accordingly, which led to different borrowing costs for sovereigns and the fragmentation of financial markets. According to Pisani-Ferry & Wolff (2012), this situation highlights the financial risk involved in the interdependence between States and banks in the euro area since it poses serious constraints to the financing needs of a country and necessarily increases the risk of sovereign debt default.

3.3. Final remarks

It can be concluded that an incomplete EMU can pose serious negative risk sharing between States and banks since it does not have the necessary mechanisms to deal, at a European level, with the probability of a State or a bank default on its payments. The assessment of the default risk of States and banks had its turning point after the world financial crisis and the most vulnerable countries of the euro area were the most affected by the negative risk perception from financial markets. Various studies on the spill-over effects between States and banks show that this correlation is higher in the euro area countries and, therefore, if completed, a Banking Union would be an effective instrument to decrease the risk perception of their economies.

4. The expected effects of the Banking Union in the risk perception of the Portuguese economy

4.1. Introduction

The following chapter assesses the expected effects of the Banking Union in the risk perception of the Portuguese economy, through an analysis of the country's 10 year Government bond yields and 5 year CDS spreads between 2001 and 2013. It takes into consideration important national economic and financial events before and after the crisis and also tries to understand how a Banking Union could have contributed to minimize their negative effects.

4.2. The Portuguese sovereign debt crisis revisited

In 7 April 2011, Portugal became the 3rd euro area country to ask for international financial assistance since it could no longer resist the pressure from financial markets on the financing conditions of its economy (Lourtie, 2011). By then, the country had already reached a 10 year Government bond yield of 9.89%, a difference of approximately 7% in comparison with Germany[9]. As regards the sovereign

[9] See Annex III.

CDS market as seen in Figure II, the country's 5 year CDS spreads recorded an historical value of more than 1000 basis points in that same year, following a gradual rise registered since the beginning of the sovereign debt crisis, in 2009.

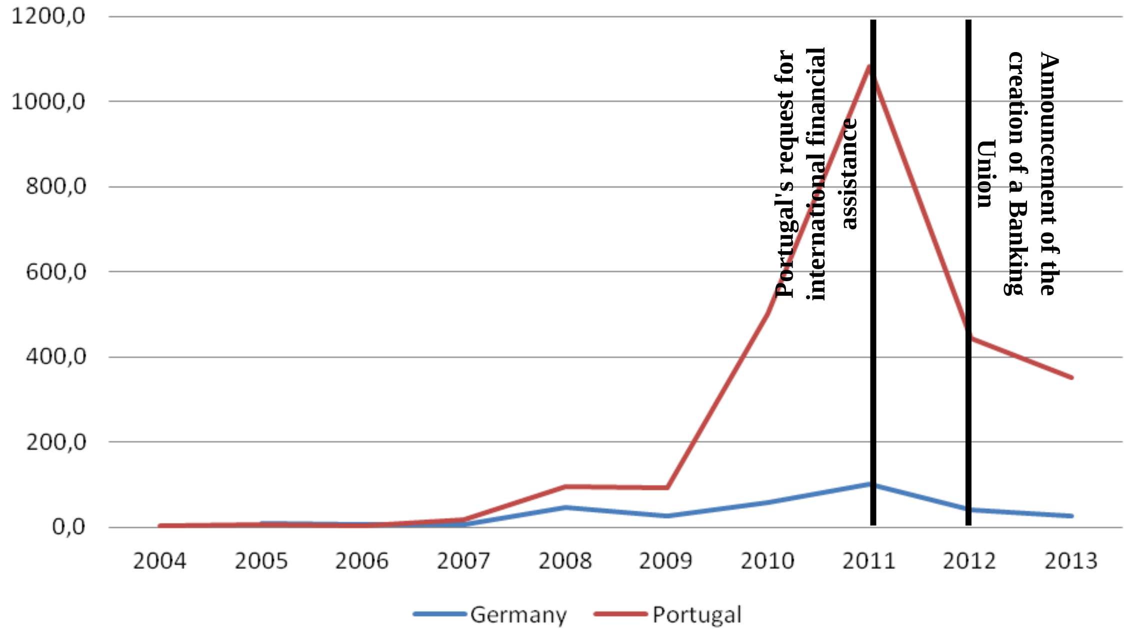


Figure II – Sovereign 5 year CDS spreads (in basis points)

Source: Author's elaboration on Bloomberg data

As Figure III shows, between 2001 and 2008, the country's cost of borrowing from financial markets was treated similarly in comparison with the German bond benchmark and, therefore, the Portuguese economy had no differentiated risk attached to it. This can also be seen in Figure II, in which it is noticeable that both the Portuguese and the German 5 year CDS spreads were not differentiated until 2007 – meaning that the risk of default of both countries was considered the same by financial markets. However, when the world financial crisis hit Europe, the country was confronted with the difficulty of adjusting in budgetary terms and overcoming credit constraints imposed by its international creditors which, after the Greek and Irish request for international financial assistance, started to see Portugal as the next country with higher probability of default due to an accumulated debt since 2001.

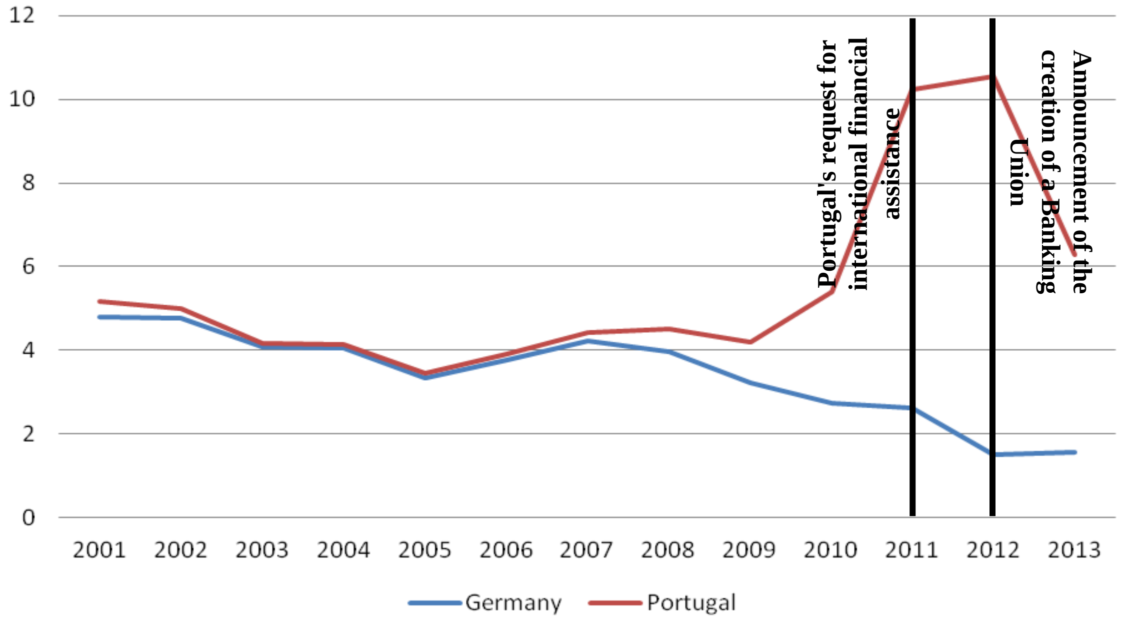


Figure III – Comparison between Portuguese and German Long-Term Government Bond Yields - 10 Year Maturity (%), annual data

Source: Author's elaboration on Eurostat and OECD data

In fact, Portuguese public finances suffered a gradual deterioration since 2001[10]. After the Greek and the Irish request for international financial assistance, the Portuguese Government debt reached more than 100% of the country's GDP in 2011[11] and the Portuguese 5 year CDS spread (see Figure II) and 10 year Government bond yields (see Figure III) recorded an historical value, which represented a downward spiral of the country's financing conditions.

[10] According to Lourtie (2011) and Caetano & Sousa (2013), Portugal's accumulated public deficit and debt can be traced back to the country's decision of channelling major part of its investment to non-tradable uncompetitive sectors that led the country to excessively import tradable goods, mainly from Northern European countries. This explains the country low economic activity since 2001.
[11] See Annex IV.

Adding to this gloomy picture was the inclusion within the State's accounts of the financial assistance given to two major national banks in 2008 – BPN – and 2009 – BPP. In fact, according to Ferreira (2009), due to their different nature, the Portuguese Government decided to take on different solutions, justifying them with the protection of public interest[12]. On one hand, needing liquidity and capital, and given the complexity of interconnections that the bank had with the real economy – meaning a higher probability of systemic risk -, the Portuguese Government decided to nationalize BPN and gave its management to CGD, a public bank that invested 1800 million euros[13]. On the other hand, since a probable bankruptcy of BPP would not cause a significant systemic risk, the Portuguese Government decided not to nationalize the bank – that remained in the hands of its creditors – and the Bank of Portugal nominated a provisory administration in order to assess the bank's real situation. In this case, the Portuguese Government involved the national banking sector – CGD, BCP, BES, BPI, *Totta Santander* and *Caixa Agrícola* –, lending 450 million as State guarantee in order to save deposits and pay loans (the State did not directly injected liquidity into BPP[14]).

As a result, when BPN and BPP asked for the State's financial assistance, the Portuguese Government had to increase its public expenditure in 2008 and 2009 while revenues decreased due to the country's low economic activity since 2001. In fact, by

[12] According to Ferreira (2009), BPN was a retail bank with over 300 thousand clients, receiving deposits and providing loans, while BPP was a niche bank that served an elite of about 3 thousand clients.
[13] In fact, "Operation Hurricane" – that investigated cases of fiscal fraud and money laundering since 2005 – led by Banco de Portugal uncovered a massive fraud in BPN in February 2008, led by its President Oliveira e Costa that had been taking money away from the bank to off-shore accounts for over 7 years. This led to the institution's insolvency due to the discovery of a 700 million euros hole that was kept from Banco de Portugal until then, which justified the intervention of Bank of Portugal, the bank's nationalization and the arrest of Oliveira e Costa. The case has been in court of justice ever since (see Ferreira, 2009).
[14] According to Ferreira (2009), it can be said that BPP is the real victim of the world financial crisis since the stocks' crash ended up showing that the bank was widely exposed to higher risk segments, preventing it from honoring its commitments. Therefore, just like it happened on other small banks all around the world with similar characteristics, the BPP became insolvent and, in 29 November 2009, its President, João Rendeiro, went to Banco de Portugal ask for its intervention in order to prevent BPP's bankruptcy.

putting at risk the national banking system, the world financial crisis helped revealing the weakness of some national banking institutions (Ferreira, 2009).

Afterwards, the NSI decided to revise upwards the figures on public deficit and public debt for 2009 and 2010 (see Lourtie, 2011), which added to the financial market's negative perception of the country's economy. As a consequence, a spiral of contagion was created between the Portuguese State and its national banks, which were then affected even further since the high risk perception of the country's sovereign debt led credit rating agencies to also downgrade the banks' credit rates, which in turn ended up by significantly decrease their credit concessions to the real economy – households and companies. According to the NSI (see Ribeiro, 2014), between 2008 and 2013, all the measures undertaken by the State to rescue national banks and stabilize the country's financial system have already cost 6134 million euros to taxpayers in operations such as payment of interests, capital injections, guaranties and the nationalization of BPN. The State was only able to recover 1399 million euros and, therefore, it remains with a 4735 million euros loss – almost 3% of the country's DGP. Some of these operations were the nationalization of BPN (1800 million euros in 2008), financial help given to BPP (450 million euros in 2009), and a capital injection in the Banif bank (700 million euros in 2013). The State was also responsible for the payment of interests of around 1700 million euros that resulted from the contraction of debt in order to hold the banking and financing sector and for the 2050 million euros accumulated in terms of capital increase in other banks.

In the end, it can be said that the risk perception of the Portuguese economy was atypical in comparison with the Greek and the Irish one, since the country's Government debt, although high, was not as severe as the Greek one[15] and its banking crisis, although serious, was not as deep as the Irish one. According to Lourtie (2011), unlike the other two countries, there was no single decisive event that undermined the financial market's sentiment towards Portugal and increased the country's risk perception. Therefore, it can be said that the contagion from the Greek and the Irish situations, Portugal's own structural economic vulnerabilities – the gradual deterioration of its public finances and low economic performance since 2001 – and the State's bail-out of some national banks added-up to form the negative financial market's perception of the risk to invest in the Portuguese economy.

4.2. How can a Banking Union contribute

The announcement of the creation of a Banking Union in June of 2012 marked a structural break in the evolution of the sovereign debt crisis and seems to have had some effect in the risk perception of the Portuguese economy. Since then, the confidence of financial markets in Portugal's ability to overcome its financial problems has gradually increased. According to Figure II, the significant decrease in Portugal's 5 year CDS spreads in 2012, from 1081.9 basis points in 2011 to less than a half in 2012 – 442.9 basis points –, and then to 351.7 basis points in 2013 demonstrates that the successful implementation of Portugal's Adjustment Programme together with initial efforts to accelerate the process of a European financial integration paid off and that the instruments already approved within the framework of a Banking Union are a step in the right direction in order to minimize the vicious cycle between States and banks by weakening the significance of the financial market's assessment of the country's risk.

[15] See Annex V.

Ever since the beginning of the sovereign debt crisis, Portugal's 2012 5 year CDS spreads scored the lowest results, reducing the difference in comparison with Germany's risk perception.

In fact, since the idea of establishing the ECB as ultimate supervisor and lender of last resort for all banks participating in the Banking Union was put forward after May 2012 (see point 2.3), together with the creation of other instruments under the ECB's responsibility – such as the OMT Programme announced in 2 August 2012 establishing that the ECB intended to purchase Government bonds of the crisis countries that had signed a Memorandum of Understanding – international creditor's confidence in Portugal's ability to repay its debt stabilised and interest rate spreads on 10 year Government bonds eased substantially, as it can be seen in Figure III. Similarly to what happened in the CDS market, Portugal's 10 year Government bonds went from 10.55% in 2012 to 6.29% in 2013, reducing the difference in comparison with the German bonds by around 4%.

Moreover, if we take into consideration Portugal's quarterly data on 10 year Government bonds, we can see that since the 2nd quarter of 2012 until the 4th quarter of the same year, there was a significant decrease, a phenomenon that to some extent can be attributed to the fact that the most important events in the creation of a Banking Union took place between May and December of 2012 (see point 2.3)[16].

Therefore, there are a number of reasons why the instruments already created within the framework of a Banking Union will contribute to continue to decrease the risk perception of the Portuguese economy. Firstly, because it was already established a lender of last resort – the ECB – that it's the ultimate supervisor of all banks in the euro

[16] See annex VI.

area and flags a bank needing to be financially assisted. These new tasks give the ECB the power to prohibit State aid – meaning bail-outs – without its prior approval and give States the opportunity to resort to a common backstop through a SRF intended for them not to increase their public expenditures and maintain balanced public finances. In fact, if a Banking Union already existed prior to the crisis, the Portuguese Government would have opted to ask for the money available through the SRF, which would not have aggravated the state of its public finances by individually financially assist BPN and BPP, which in turn undermined the international creditor's confidence in the country's ability to meet its financial obligations and led to a rise of the country's Government bonds and CDS spreads – which meant a rise of Portugal's risk perception. Secondly, because without the direct link between the State's guarantee to financially assist a needing bank, taxpayers money and, ultimately, the economy as a whole, would not have been used to rescue severe indebted banks, as it was the case of the nationalization of BPN, with the private sector bearing the costs of the financial burden.

Overall, a Banking Union will allow for a kind of mutualisation of the risk perception, whether it comes from sovereigns or their national banks, since it creates a centralized structure that reduces the risk of a loss of confidence from financial markets by assuring that a participating Member-State does not bear alone the refinancing costs of helping a needing bank that leads to the burden of an unsustainable public debt and the country's inability to meet its financial obligations. In other others, it prevents a national banking crisis such as it happened with BPN – and BPP, although on a smaller scale – from facilitating a crisis of the State's public finances. Therefore, the introduction of the SSM and the SRM is a positive first step in that direction, even if some of its initial elements and coverage have been limited after being negotiated (see point 2.3 and 2.4).

However, although the Banking Union is an essential part of the solution, it is not the solution itself. For example, the OMT Programme and the continued efforts at a national level to successfully implement the country's Financial Adjustment Programme also contributed to decrease the perception that the Portuguese economy was financially unsustainable.

4.3. Final remarks

It can be concluded that the announcement of the creation of a Banking Union in the summer of 2012 seems to have had some positive effects in the risk perception of the Portuguese economy. In fact, through the assessment of recent trends in 10 year Government bond yields and 5 year CDS spreads, it can be said that initial efforts to accelerate the process of financial stability are showing results and that the instruments already approved within the framework of the Banking Union are a step in the right direction. Therefore, it can be stated that since the initial call for a Banking Union, together with the OTM Programme and continued efforts at a national level to successfully implement the Financial Adjustment Programme, confidence of financial markets in Portugal’s ability to overcome its financial problems has gradually increased.

Conclusion

Overall, a complete Banking Union will allow for a kind of mutualisation of the risk perception since it creates a centralized structure that reduces the risk of a loss of confidence from financial markets by assuring that a participating Member-State does not bear alone the refinancing costs of helping a national needing bank.

Through a SSM, a SRM and a DGS, participating Member-States will not have to worry about the risk dynamics between their sovereign debt and their national banks' debt since they will be integrating a complete single currency area after EMU's financial integration is complete. By integrating such an area, what once exacerbated existing national weaknesses will then give the most needed backstop that the area did not had before. In fact, if completed, a Banking Union will implement a tight control on banks and will provide effective European help to those in risk of failure. In the end, this kind of European backstop will replace what was once considered and treated as a national matter and, thus, it is expected that financial markets' risk perception of a certain economy will soon be reduced by a risk sharing architecture within the euro area.

As regards the Portuguese economy, it is clear that the nationalization of BPN facilitated the burden of an unsustainable public debt accumulated since 2001 which then led to Portugal's inability to meet its financial obligations. Although the country also suffered from the negative spill-over effects from Greece and Ireland's financial situation, existing national weaknesses led financial markets to associate it with a higher risk of going into default. As a result, it can be stated that if a complete Banking Union had already been settled, than the vicious cycle between the Portuguese economy and its national banks would have already been broken and Portugal would have been able to prevent the serious consequences of the nationalization of BPN. However, as long as the Banking Union is not completed, the country and the other euro area countries will continue to be vulnerable to any kind of financial crisis and will remain exposed to problems in their national banking systems.

In fact, more recently Portugal suffered another setback in its recovery process with the collapse of one of its most important banks – BES –whose resolution process is still ongoing. The announcement of financial problems led international creditors to fear the bank's failure and soon its stock value dropped and Portuguese yields increased with the perspective of BES asking for the State's financial assistance. As a result, the BES case was seen in Portugal has a revival of the BPN case, once again questioning the stability of the national banking sector, the readiness of European help and the efficiency of stress tests. Hence, it can be stated that if the Banking Union had already been completed than Portugal would have been able to prevent the serious consequences of the BES case and the increasing risk perception that again began to be associated with its sovereign debt. Moreover, even though the bank will not be bailed-out, whatever happens with BES will still remain a national issue.

In conclusion, this Dissertation allowed for a better understanding of the risk dynamics between States and banks that undermined the euro area after the world financial crisis in the framework of an incomplete EMU and more specifically for Portugal how that vicious cycle affected the country's sovereign risk. The main goal was to contribute to the debate on the advantages of a Banking Union for Europe and specifically for Portugal since time and space limitations made impossible to also assess the challenges the creation of a Banking Union may pose for its Member-States. Thus, future studies on the matter are needed to better understand what problems may lay ahead with the completion of its institutional architecture. Also, additional economic and financial (banking) indicators can be used in future investigations to better assess the real level of correlation between the Portuguese economy and its banks that helps explaining the country's high sovereign risk perception by financial markets.

References

Acharya, V. *et al.* (2011). A Pyrrhic Victory? Bank Bailouts and Sovereign Credit Risk. *National Bureau of Economic Research* (17136), 1-41.

Alesina, A. & Grilli, V. (1991). The European Central Bank: Reshaping Monetary Politics in Europe. *National Bureau of Economic Research* (3860), 1-37.

Alter, A. & Schuler, Y. (2011). Credit Spread Interdependencies of European States and Banks during the Financial Crisis. *Journal of Banking & Finance* 36 (12), 3444-3468.

Angeloni, C. *et al.* (2012). Policy Lessons from the Eurozone Crisis. *The International Spectator: Italian Journal of International Affairs* 47 (4), 17-34.

Barker, A. (2014). European banking union: Foundations laid but bricks still to fall in place [Online]. Available at: http://www.ft.com/intl/cms/s/0/7c3c8cd8-cee2-11e3-8e62-00144feabdc0.html#axzz34K6Kjq00 [Accessed on: 2014/06/11].

Bloomberg database [Accessed on: 2014/07/26].

Caetano, J. & Sousa, M. (2012). A herança de Maastricht: das suas condicionantes às perspetivas de sustentabilidade da UEM a longo prazo. *Debater a Europa – Periódico do CIEDA e do CEIS20, em parceria com GPE e a RCE* (6), 41-66.

Caetano, J. & Sousa, M. (2013). Será a União Bancária uma solução para a crise do euro?. *Debater a Europa - Periódico do CIEDA e do CEIS20, em parceria com GPE e a RCE* (8), 87-109.

Commission of the European Communities (2008). Communication from the Commission to the European Council – A European Economic Recovery Plan [Online]. Available at: http://ec.europa.eu/economy_finance/publications/publication13504_en.pdf [Accessed on: 2014/07/15].

Council of the European Union (2009). Press release 2972nd Council meeting – Economic and Financial Affairs [Online]. Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111025.pdf [Accessed on: 2014/07/15].

Council of the European Union (2013a). Council Regulation (EU) nº 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions. *Official Journal of the European Union* (287), 63-89.

Council of the European Union (2013b). Council agrees general approach on Single Resolution Mechanism [Online]. Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/140190.pdf [Accessed on: 2014/04/16].

Davies, H. (2012). Europe's Flawed Banking Union [Online]. Available at: http://www.project-syndicate.org/print/europe-s-democratic-deficit-goes-to-the-bank-by-howard-davies [Accessed on: 2014/04/16].

De Grauwe, P. (2013). The Political Economy of the Euro [Online]. Available at: file:///C:/Users/Nadine%20Teles/Downloads/De_Grauwe_annurev-2013.pdf [Accessed on: 2014/07/18].

De Santis, R. (2012). The euro area sovereign debt crisis: safe haven, credit rating agencies and the spread of the fever from Greece, Ireland and Portugal. *European Central Bank – Macroprudential Research Network* (1419), 1-59.

Dias, T. & Abreu, M. (2012). A Crise da Dívida Soberana Portuguesa Lida Através dos Spreads dos CDS da Dívida Portuguesa Relativamente aos CDS da Dívida Alemã. *School of Economics and Management – Department of Economics Working Papers* (39), 1-25.

Elliot, D. (2012). Key Issues on European Banking Union – Trade-Offs and Some Recommendations. *Global Economy & Development* (52), 1-55.

European Central Bank (2014). *Statistical Data Warehouse* [Data base], May 2014. Frankfurt: European Central Bank. Available at: http://sdw.ecb.europa.eu/browseTable.do?REF_AREA=258&node=bbn192&sfl2=4&DATASET=0&sfl3=4&SERIES_KEY=121.GST.A.PT.N.E0X13.MAL.E1300.SA.G.

European Commission (2012a). Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank - Action for stability, growth and jobs [Online]. Available at: http://ec.europa.eu/europe2020/pdf/nd/eccomm2012_en.pdf [Accessed on: 2014/04/15].

European Commission (2012b). Communication from the Commission to the European Parliament and the Council – A Roadmap towards a Banking Union [Online]. Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0510:FIN:EN:PDF [Accessed on: 2014/04/16].

European Commission (2013). Commission proposes Single Resolution Mechanism for the Banking Union [Online]. Available at: http://europa.eu/rapid/press-release_IP-13-674_en.htm?locale=en [Accessed on: 2014/04/16].

European Commission (2014a). European Parliament and Council back Commission's proposal for a Single Resolution Mechanism: a major step towards completing the banking union [Online]. Available at: http://europa.eu/rapid/press-release_STATEMENT-14-77_en.htm?locale=en [Accessed on: 2014/04/16].

European Commission (2014b). A comprehensive response to the financial crisis: substantial progress towards a strong financial framework for Europe and a banking union for the Eurozone [Online]. Available at: http://europa.eu/rapid/press-release_MEMO-14-244_en.htm?locale=en [Accessed on: 2014/04/16].

European Commission (2014c). *Government finance statistics* [Data base], April 2014. Brussels: Eurostat. Available at: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=0&language=en&pcode=tsdde410.

European Council (2009). European Council 10/11 December 2009 conclusions [Online]. Available at: http://www.consilium.europa.eu/uedocs/cmsUpload/st00006.en09.pdf [Accessed on: 2014/07/15].

European Council (2010). European Council 25/26 March 2010 conclusions [Online]. Available at: http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/113591.pdf [Accessed on: 2014/07/15].

Ferreira, C. (2009). BPN e BPP: dois casos que a crise veio pôr a descoberto [Online]. Available at: http://www.publico.pt/economia/noticia/bpn-e-bpp-dois-casos-que-a-crise-veio-por-a-descoberto_1355509 [Accessed on: 2014/08/03].

Ferreira, P. & Caetano, J. (2013). Integração financeira incomplete: zona Euro em xeque?. *Debater a Europa – Periódico do CIEDA e do CEIS20, em parceria com GPE e a RCE* (8), 65-86.

Foarta, O. (2014). The limits to partial banking unions: A political economy approach. [Online]. Available at: http://www.voxeu.org/article/limits-partial-banking-unions [Accessed on: 2014/07/21].

Folkerts-Landau, D. & Garber, P. (1992). The European Central Bank: a Bank or a Monetary Policy Rule. *National Bureau of Economic Research working papers series* (4016), 1-33

Gerlach, S *et al*. (2010). Banking and Sovereign Risk in the Euro Area. *Deutsch Bundesbank Eurosystem Discussion Paper* 1 (9), 1-57.

Goyal, R. *et al.* (2013). A Banking Union for the Euro Area. *International Monetary Fund Discussion Note*, 1-31.

Gros, D. (2013). The European Banking Disunion [Online]. Available at: file:///C:/Users/Nadine%20Teles/Downloads/DGros%20Commentary%20EU%20Banking%20Disunion%20(1).pdf [Accessed on: 2014/07/18].

Huertas, T. (2012). Banking Union: What Will It Mean For Europe? *LSE Financial Markets Group Paper Series* (213), 1-7.

Lourtie, P. (2011). Understanding Portugal in the Context of the Euro Crisis [Online]. Available at: http://www.iie.com/publications/papers/lourtie20110913.pdf [Accessed on: 2014/06/25].

Merler, S. & Pisani-Ferry, J. (2012). Who's afraid of sovereign bonds? *Bruegel Policy Contribution* (2), 1-8.

Organization for Economic Co-operation and Development (2014). *Key short-term indicators* [Data base], June 2014. Paris: OECD. Available at: http://stats.oecd.org/index.aspx?r=463959#.

Pisani-Ferry, J (2012). The Euro Crisis and the New Impossible Trinity. *Bruegel Policy Contribution* (1), 1-16.

Pisani-Ferry, J & Wolff, G. (2012). The Fiscal Implications of a Banking Union. *Bruegel Policy Contribution* (2), 1-8.

Ribeiro, L (2014). Bancos já custaram 4735 milhões aos contribuintes [Online]. Available at: http://www.dinheirovivo.pt/economia/interior.aspx?content_id=3900164&page=-1 [Accessed on: 2014/08/03].

Schiliro, D. (2014). Changes in Eurozone Governance after the Crisis and the Issue of Growth. *International Journal of Social Science Studies* 2 (2), 110-119.

Steinhauser, G. & Stevens, L. (2013). German savings banks flex political muscle – Sparkassen have punched loopholes into Europe's postcrisis banking laws [Online]. Available at: http://online.wsj.com/news/articles/SB1000142405270230366140457917787301507483 0 [Accessed on: 2014/06/16].

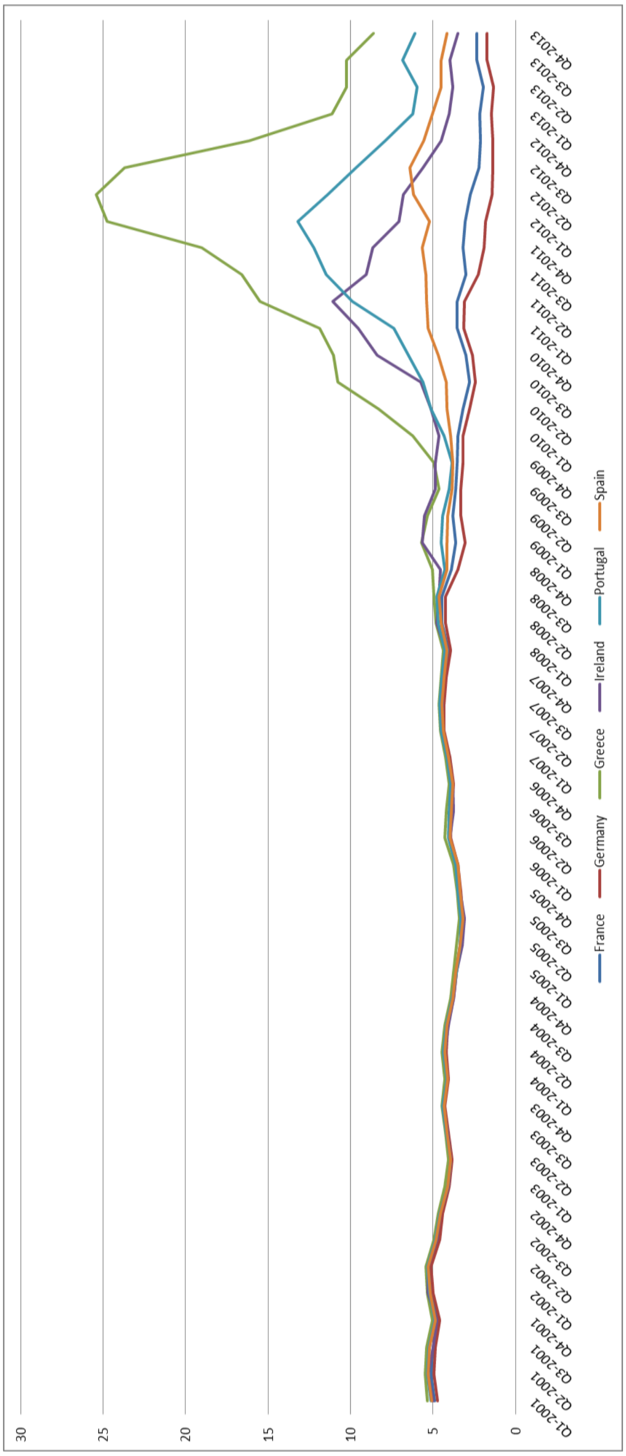
Van Rompuy, H. (2012). Towards a genuine Economic and Monetary Union – Report by President of the European Council Herman Van Rompuy [Online]. Available at: https://www.ecb.europa.eu/ssm/pdf/report/ReportbyPresidentofEuropeanCouncil2012-06-26EN.pdf [Accessed on: 2014/04/16].

Van Rompuy, H. *et al* (2012). Towards a genuine Economic and Monetary Union [Online]. Available at: https://www.ecb.europa.eu/ssm/pdf/4preport/fourpresidentsreport2012-12-05EN.pdf [Accessed on: 2014/04/16].

Wilson, J. et al (2012). Germany's small banks fight union plans [Online]. Available at: http://www.ft.com/intl/cms/s/0/efc129b0-3b00-11e2-b3f0-00144feabdc0.html#axzz34K6Kjq00 [Accessed on: 2014/06/11].

Appendix

Annex I – Long-term Government bond yields – 10 year maturity (%), quarterly data



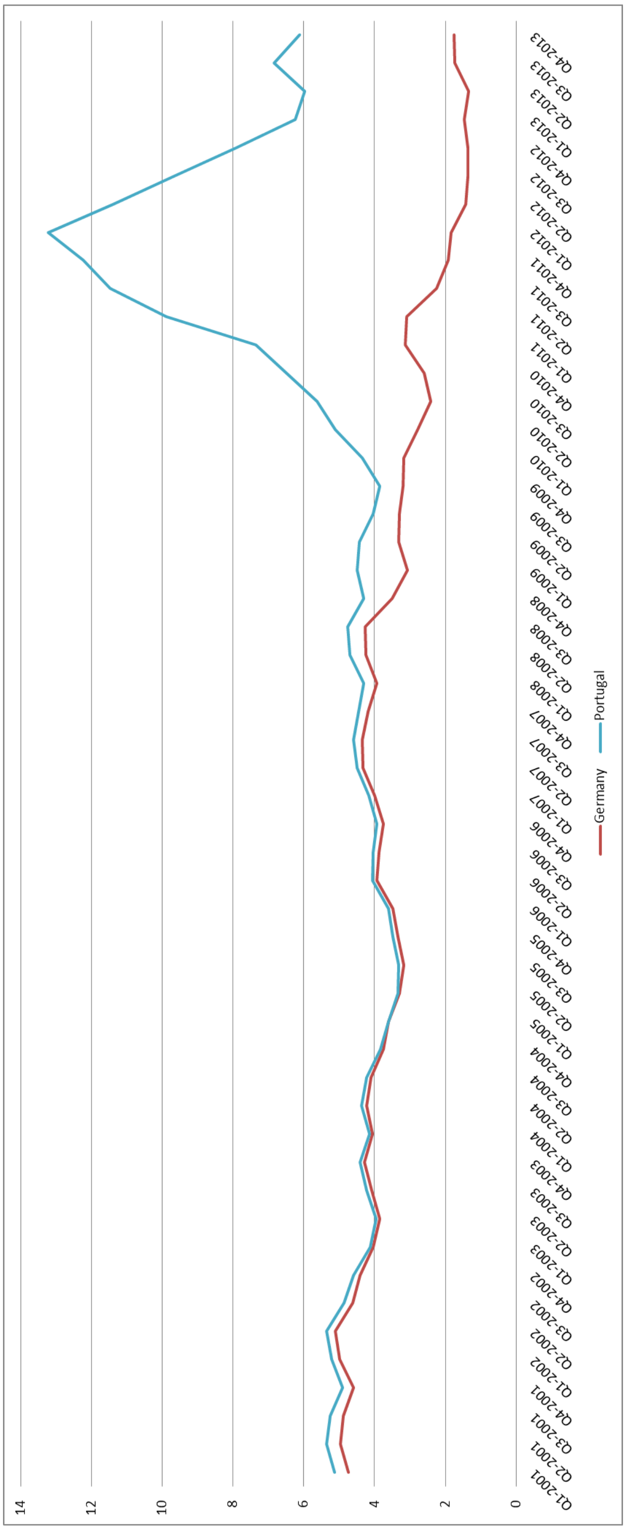
Source: Author's elaboration on Eurostat and OECD data

Annex II – Stages and instruments for a genuine EMU in terms of financial integration

<table>
<tr><td colspan="3">Integrated financial framework</td></tr>
<tr><td>Stage I
Completed end 2012-2013</td><td>Stage II
Start 2013-completed 2014</td><td>Stage III
Post 2014</td></tr>
<tr><td>Ensuring fiscal sustainability and breaking the link between banks and sovereigns</td><td>Completing the integrated financial framework and promoting sound structural policies at national level</td><td>Establishing a EMU country-specific shock absorption function</td></tr>
<tr><td colspan="3">Single Supervisory Mechanism and Single Rulebook</td></tr>
<tr><td colspan="3">Harmonised national Deposit Guarantee Schemes</td></tr>
<tr><td>Harmonised national resolution frameworks</td><td colspan="2" rowspan="2">Single Resolution Mechanism with appropriate backstop arrangements</td></tr>
<tr><td>European Stability Mechanism direct bank recapitalisation</td></tr>
</table>

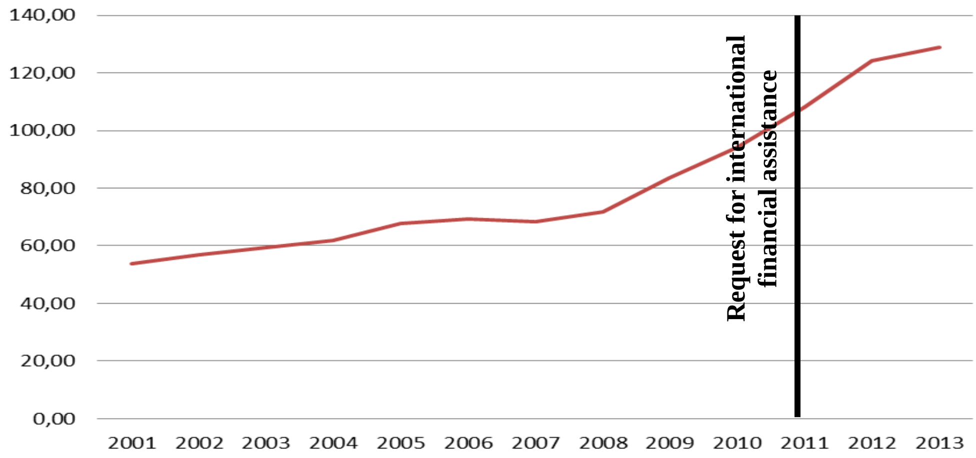
Source: Van Rompuy et al (2012), p.18

Annex III - Comparison between Portuguese and German Long-Term Government Bond Yields - 10 Year Maturity (%), quarterly data



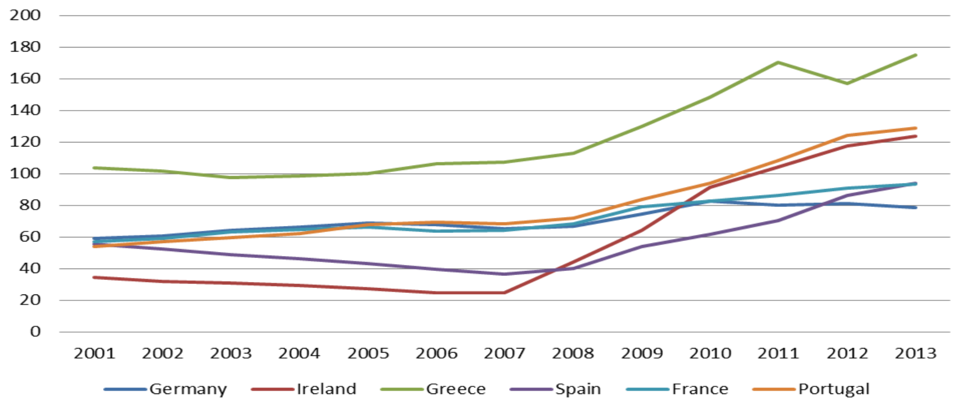
Source: Author's elaboration on Eurostat and OECD data

Annex IV – Portuguese General Government Gross Debt (% of GDP)



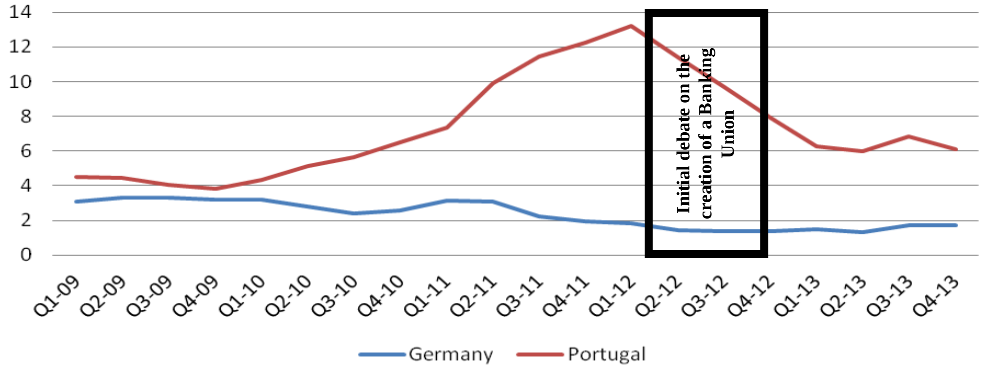
Source: Author's elaboration on Eurostat and ECB data

Annex V – General Government Gross Debt (% of GDP)



Source: Author's elaboration on Eurostat data

Annex VI – Comparison between Portuguese and German Long-Term Government Bond Yields – 10 Year Maturity (%), quarterly data



Source: Author's elaboration on Eurostat and OECD data