FINANCIAL INTEGRATION IN THE EUROZONE: THE CASE OF THE BANKING UNION

By
Alfredo Hernández Sánchez

Submitted to

Central European University
Department of International Relations and European Studies

In partial fulfilment of the requirements for the degree of Master of Arts in International Relations and European Studies

Supervisor: Professor László Csaba
Word Count: 12,869

Budapest, Hungary

2014

CEU eTD Collection

Abstract

The 2008 financial crisis exposed some of the weaknesses in the European financial system and in the Eurozone. The main objective of this thesis is to tease out the causes that led Eurozone members to agree to yield supervisory prerogatives to the European Central Bank and to agree to a Common Resolution Mechanism and Fund. The Banking Union was possible due to satisfactory demand and supply side conditions. On the supply side, the existence of the institutional framework of the EU enabled the emergence of an arrangement. On the demand the pursuit of a more stable currency union set the incentives for increased financial integration by reducing two sources fragmentation: political risk and moral hazard. The crisis created the public demand for reform and shaped it on two principles a) increased accountability and transparence and b) fiscal neutrality. The governments of Member States faced a delicate tradeoff between the (often conflicting) demands of their constituencies, the market conditions, and their own preferences for maintaining regulatory autonomy. It is argued that rather than a complete remedy to the political fragmentation that caused the fragmentation of the EU sovereign bond markets, the Banking Union is a crisis management tool, a tool that was designed upon the notion that increasing economic integration in the European Union is the correct strategy.

CEU eTD Collection

Acknowledgments

I am very grateful to all of the people that helped and inspired me to finish this thesis. I thank my family for always being there and for helping me fulfill the long-standing dream of studying abroad, my mother and brother for their endless support, my father for his insights and advice. I would also like to thank my professors at CEU for their guidance and comments, and my supervisor, Dr. László Csaba, in particular for interest and support throughout the process. I would also like to mention my appreciation for my colleagues, friends and classmates, who made the process of writing this thesis much more pleasant and fruitful. Finally, I would like to thank the Central European University for all of its support and funding for this project.

CEU eTD Collection

Contents

CEU eTD Collection

Introduction

The 2008 financial crisis exposed some of the weaknesses in the European financial system and in the Eurozone.[1] The external shock to the availability of credit revealed the negative effects that political fragmentation –a single currency with various political units– had on the stability of the European banking sector. In September 2012, the European Commission published a proposal for a Banking Union (BU) meant to complete and strengthen the monetary union. Among the elements that comprise this proposal, the Single Supervisory Mechanism (SSM) seeks to break the pernicious relation between domestic regulators and large private financial institutions while the Single Resolution Mechanism (SRM) seeks to harmonize the procedures for dealing with failed banks.[2]

Though a substantial amount of literature on the Banking Union has recently been published, most of it is the product of think tanks and special-interest groups[3], with very few academic publications[4] as of yet. This presents a unique opportunity to advance the study of financial integration from a political economy standpoint.

In their overview of the literature on International Political Economy (IPE), Frieden and Martin[5] argue that, in the case of finance, "our knowledge is more rudimentary, with some intriguing puzzles and preliminary analyses, but only relatively sketchy theoretical and empirical

CEU eTD Collection

[1] This section is based on an unpublished paper submitted by the author to the Department of International Relations and European Studies at the Central European University (2014)
[2] (European Commission 2012)
[3] (Véron 2013, Elliot 2012, Whyte 2012, Valiante 2014)
[4] (Allen, Carletti and Gray 2013, Howarth and Quaglia 2013)
[5] (Frieden and Martin 2003, 131)

work." While there is an ample theoretical and empirical background on the subject of monetary issues[6], relatively few has been written on the factors that drive financial policy choices.

The systemic importance of international finance and the risks associated with it have been made evident by a series of financial crises across the globe. However, international efforts to govern global finance have yielded meager results.[7] The issues of finance in general and macro-prudential regulation in particular are commonly seen as obfuscated, arcane, and solely the realm of economists and formal econometric models.[8] The subfield of the IPE of international finance is at a similar stage as that of monetary relations in past decades. A documented account of the financial integration process in the Eurozone would shed new light on the political undertones of an esoteric an issue as financial regulation.

More importantly, the future of the Banking Union is likely to determine not only the long term viability of the Eurozone, but also the role of the Euro in the international monetary system. The conclusions of this proposed thesis can contribute to both policy and literature by describing the process that gave birth to the Banking Union and setting the stage for a further analysis of its implications not only for Europe but for the global economy.

The main objective of this thesis is to tease out the causes that led Eurozone members to agree to yield supervisory prerogatives to the European Central Bank and to agree to a Common Resolution Mechanism and Fund. The current literature suggests that efforts for international regulatory harmonization in finance are a function of either a trade-off between competitiveness and stability[9] or of regulatory capture[10]; this, however, is not an adequate framework to study the

[6] (Broz and Frieden 2001, Frankel 1998, Cohen 1993, Eichengreen 2011)
[7] (Germain 2012)
[8] (Mosley and Singer 2009)
[9] (Singer 2004, Simmons and Elkins 2004)

CEU eTD Collection

case of the Banking Union. My hypothesis is that the Banking Union is an example of financial integration designed to eliminate some of the deficiencies that stem from the political fragmentation that characterizes the Eurozone; namely political, redenomination and moral risks. Consequently, it gained political traction not only because it reduces systemic risk but because it is the minimum common denominator that the Eurozone members could agree upon due to their reluctance to give away too much control over their domestic financial sectors or to bring fiscal matters to the negotiating table. The BU, though inspired by a general goal of stability, is shaped by diverging preferences in a trade-off between stability and sovereignty.

In order to make my hypothesis viable, evidence to support the following premises must be found:

a) The negotiators involved in the process faced a dilemma between the economic needs of the Eurozone and the political demands that arose in the aftermath of the sovereign debt crisis
b) Political fragmentation in the Eurozone is a source of instability due to the redenomination and political risks that stem from it
c) The Banking Union addresses some of the economic design deficiencies of the European Monetary Union (EMU) but within the constraints of the purposive relationships among Eurozone Member States and the societal demands for increased accountability and fiscal neutrality

In order to demonstrate the first premise, I review the current literature on financial integration and propose a framework based on Two-Level Game logic[11] and the supply and

[10] (Lall 2012, Major 2012, Gourevitch 2013)
[11] (Putnam 1988)

CEU eTD Collection

demand side forces that drive regulatory outcomes[12]. Though most descriptive cases in IPE build on a mature literature with recurring empirical regularities; cases of financial regulatory harmonization are mostly either at the global level or have failed to achieve their goals and there are no evident cases of financial integration beyond capital account liberalization. To compensate for this, I propose a descriptive approach, backed by an extrapolation of the conceptual frameworks and empirical regularities of the IPE of monetary integration[13]. Though it has been argued that descriptive case studies make little effort to engage the existing literature[14], in cases where the prior knowledge is not developed or the evidence is not yet conclusive then these methodologies can be of great value.

For the second premise, I propose a cross-sectional analysis of the differences between the financial systems within the Eurozone before and after the crisis, focusing on indicators of (in)stability such as government bond interest rates (Political Risk) and intra Eurozone loans (Home Bias). The objective is to demonstrate that the exogenous shock to stability surfaced some of the design flaws of the currency union, namely the redenomination and political risks that impede the proper functioning of monetary policy in the Eurozone.

For the third, I propose the use of a systematic examination of diagnostic data –process tracing– to tease out the causal paths that led to cooperation patterns. This approach, though still in early stages of development within the field[15], has allowed researchers to gain more insight on the politics of international financial regulation[16]. In that tenor, I suggest the use of the criteria set

CEU eTD Collection

[12] (Mattli and Woods 2009)
[13] (Broz and Frieden 2001)
[14] (Odell 2001, 162-163)
[15] (Collier 2011)
[16] (Mosley and Singer 2009, Lall 2012, Young 2012, Odell 2001)

forth by Collier[17] to determine the diagnostic value of the evidence collected from a rigorously sequence-organized qualitative data set composed of interviews with participants, intra-institutional dossiers and press releases. This combination of qualitative and quantitative methodologies is necessary in order to achieve a comprehensive understanding of both the political and economic underpinnings of the phenomenon.

The thesis is organized in three sections. The first is an overview of the literature on financial integration and an analytical framework proposal. The second analyses the Eurozone financial system before and after the crisis. The third consists of a description of the elements and functions of the Banking Union in its present state and explores the response to the crisis as well as the trade-offs faced by national governments during the Banking Union process. The thesis ends with some conclusions on the possible implications of the Banking Union and reflects on further areas of opportunity for research.

CEU eTD Collection

[17] (Collier 2011, 824)

Chapter One- Financial Integration: a two-level game approach to the Banking Union

Literary Overview

The macroeconomic transformations of the 1970s, chief amongst which was the collapse of the post-war monetary arrangements, led scholars of IPE to take an interest in new topics such as exchange rate regimes[18], capital account liberalization[19] and the institutional aspects of central banking[20]. Those crises proved to be windows of opportunity for the advancement of the IPE subfield and sparked a rich and growing literature.

The recent global financial crisis has surfaced new and unexplored analytical puzzles for the IPE of finance.[21] Issues such as the determinants of regulatory cross-national variation, the role of pressure groups and the causes behind patterns of cooperation and discord within global regulatory bodies present a vast area of opportunity of research.[22] Though there are mature debates within the IPE of financial regulation that have to do with issues such as the implications of "too big to fail" financial institutions[23], the tradeoff between stability and competitiveness and "race-to-the-bottom" regulatory arbitrage[24]; "more research is required to understand the conditions under which the multiplication of institutions […]fosters regulatory convergence, and the circumstances under which this proliferation generates centrifugal pressures that lead to

CEU eTD Collection

[18] (Cohen 1993, Frankel 1998, Broz and Frieden 2001)
[19] (Wyplosz 2002, Goodman and Pauly 1993)
[20] (Waller 1989, Garman 1989)
[21] This section is based on an unpublished paper submitted by the author to the Department of International Relations and European Studies at the Central European University (2014)
[22] (Mosley and Singer 2009, 10)
[23] (Goldstein and Véron 2011)
[24] (Singer 2004, Claessens y Laeven 2004, Vogel and Kagan 2002)

regulatory fragmentation."[25] Although the study of cooperation/discord patterns in global financial governance has been overhauled after the crisis[26], most of these studies are the accounts of failed attempts at international financial governance[27].

A common argument in the field is that there is a new architecture of international finance in which regulation is characterized by *ex profeso* technocratic obfuscation intended to insulate it from democratic demands[28]. Recent studies on international efforts to regulate finance have focused on the issue of regulatory capture[29] taking as a case study the Basel Committee on Banking Supervision (BCBS). However, these studies draw conflicting conclusions and the causal paths of regulatory capture are not yet clear.[30] This literature, as well as that on the issue of 'Too Big to Fail' financial institutions[31], suggests that efforts to regulate large transnational banks are set to fail and that capture is the norm. Though the existence of large systemically relevant financial institutions does present new challenges to State structures[32], a more sophisticated understanding of its influence in political outcomes is required.

Despite the commonly held belief that economic integration and increasing competition would result in a race-to-the-bottom regulatory deregulation trend, this has not been validated

[25] (Mosley and Singer 2009, 425)
[26] (Wood 2005, Young 2012, Mattli and Woods 2009)
[27] (Lall 2012, Major 2012, Helleiner and Porter 2009)
[28] (Major 2012, 536)
[29] Regulatory capture occurs when a regulatory agency that was created to promote general welfare ends up advancing the interests of the industry it was tasked with overseeing or when regulations meant to maximize general welfare are successfully lobbied against by narrow interests that have a conflict of interest. (Lall 2012, Mattli and Woods 2009)
[30] Whereas some authors (Lall 2012, 609, Helleiner and Porter 2009) find evidence of capture in Basel II, others (Young 2012, 663) state that the evidence of regulatory capture in the case of the BCBS's Basel II agreement is contradictory and proposes a more nuanced understanding of the financial sector's influence in the process.
[31] (Goldstein and Véron 2011)
[32] (J. A. Frieden 1991, Goodman and Pauly 1993)

CEU eTD Collection

theoretically or empirically.[33] By building on the literature on the impact of globalization in domestic policies, Vogel and Kagan propose a framework that systematizes the race-to-the-bottom/race-to-the-top (laxity/stringency) regulatory dynamics (convergence/divergence). The logic of race-to-the-bottom regulation is that in an increasingly more integrated world economy, governments are forced to relax regulations in order to attract or keep ever-more-mobile capital in the jurisdiction. However, there is little evidence to support this claim. What has been observed, counter intuitively, is that there is an increase in global efforts for more effective governance of issues such as international finance.

The Banking Union proposal is one of these efforts. Vogel and Kagan[34] assert that in order to understand the impact of globalization on domestic regulatory policies it is necessary to view the process not only as increased economic interdependence, but also as an expansion of international social and political interaction. Though there is evidence that in some cases there has been stricter regulation in the face of globalization, the process has not impacted regulatory policies as was expected by most of its critiques and advocates. The Banking Union case presents thus an opportunity to explore the factors that lead stricter regulation of finance at the international level, particularly given the secular trend of regulatory laxity that has characterized the global financial system.

These factors, however, remain a vastly underexplored subject. Though most studies on financial integration focus on its capital account liberalization dimension[35], this process is about more than just the absence of capital controls and its macro prudential regulatory dimension must

CEU eTD Collection

[33] (Vogel and Kagan 2002)
[34] Ibid.
[35] (Goodman and Pauly 1993, Alesina, Grilli and Milesi 1993)

not be ignored.[36] Nonetheless, the process of economic integration in Europe presents certain political particularities that must be taken into account. Considering the Banking Union as another step in the economic integration process, a relevant point of inquiry is the elements that led Eurozone members to agree to yield supervisory prerogatives to the European Central Bank and to set a common Bank Resolution Mechanism and Fund.

Analytical Framework

In their seminal book, "The Politics of Global Regulation", Mattli and Woods[37] seek to identify the underlying causes behind regulatory outcomes. They argue that there are demand and supply side driven forces behind each step of the process.[38] According to the authors, in the absence of a broad and inclusive demand for regulation and a transparent institutional framework[39] regulatory capture is the eventual outcome. The authors base their framework on the postulates of the proceduralist school of public good but stress that this school of thought neglects the demand side of regulation by limiting its focus to institutional design. This demand, in turn, may never form due to informational asymmetries or public action constraints. On the supply side, less transparent institutions are easier to capture either *de jure* or *de facto*. Nevertheless, there are

[36] Despite opposing views on its utility, the foremost example of macro prudential regulatory convergence is the capital adequacy standards established by the Basel Committee on Banking Supervision. Likewise, there are some examples of regional financial initiatives –among them the Chiang Mai Initiative, the Asian Bond Market and the Asian Currency Unit developed in East Asia after the 1997 crisis (Chul and Wyplosz 2010).

[37] (Mattli and Woods 2009)

[38] The authors identify the following stages: a) agenda setting, b) design and c) enforcement. (Mattli and Woods 2009) For the purposes of this thesis, only the first two stages are considered. Another approach is that of Solingen (2008), who identifies the stages as i) genesis, ii) design and iii) effects. On all accounts, the study of the Banking Union is, at the moment of writing this paper, limited to the puzzles that arise from the first two steps.

[39] There are three mains schools of thought surrounding the concept of public good: a) idealist, b) rejectionist and c) proceduralist. The first states that regulators have common welfare as an automatic objective, the second argues that common welfare is never a policy objective while the third assumes a middle-of-the-road position by stating that common welfare regulation is contingent on a transparent and open process in regulatory design.

CEU eTD Collection

some societal actors and coalitions that can form in favor of common interest regulation and an informed and sustained demand is a theoretically plausible outcome.

In the case of economic integration, Mattli[40] argues that both demand and supply side conditions must be met in order to have successful outcomes. Taking design and genesis as exogenous, Mattli focuses mainly on the effects of regional integration schemes and preforms a historical overview to identify success and failure trends. It is argued that regional processes that fulfill both supply and demand side requirements have a greater chance of succeeding. In order to explain the Banking Union, it is thus necessary to explore both the supply and demand side conditions for the emergence of the new regulatory arrangement. Due to the complexity of the institutional dimension of the European Union (EU), the supply side conditions are taken as a constant, *a sine qua non condition* determined exogenously by the configuration of the international strategic environment[41], and special emphasis is given to the demand side conditions; namely, the economic necessity of increased macroeconomic stability under the constraint of the political demands from the constituencies of the Member States.

Considering the Banking Union as a further step in the economic integration process of the European Union as well as an international financial regulatory outcome, its genesis and design can be explained by the regulatory supply/demand forces outlined *supra*. The national governments and European institutions involved in the negotiation process reacted to both the domestic demands for regulation and their own, and often diverging, economic interests.

In order to determine the causes that led to the Banking Union arrangement, it is necessary to focus on the importance of both domestic and international factors. Robert Putnam

[40] (Mattli 1999)
[41] (Frieden and Martin 2003)

CEU eTD Collection

outlines a theoretical framework of international negotiations in which outcomes are determined by the interplay between a) domestic coalitions around policy issues and b) national governments maximizing their capacity to respond to their constituencies and externalize the negative consequences of foreign developments.[42] This framework is particularly useful for the study of international regulatory outcomes as it considers the importance of both the demand side (domestic factors) and the supply side (the strategic environment) elements of the process.

The two-level game metaphor proposed by Putnam[43] suggests that national governments act as mediators between domestic and international inputs. The model identifies a "win-set" in which all outcomes (international arrangements of any type) that are perceived to be as more favorable than the status quo by the constituency fall. The concept of "win-set" is complemented by that of the "acceptability-set"[44], which refers to the arrangements that are perceived as an improvement to the *status quo* by the Chief of Government (CoG). According to this approach, the international arrangements that are viable are those that enter in both the acceptability and the win set, in other words, those that are deemed an improvement by both society and the national governments involved.[45] Thus, the Banking Union's genesis is a function of the interplay between the supply and demand side conditions for regulatory reform that set the incentives for national governments to reach an arrangement that falls within the bounds of the acceptability and win sets (design). In the following sections, the supply and demand side conditions are further explored.

CEU eTD Collection

[42] (Putnam 1988, 434)
[43] Ibid.
[44] (Frieden and Martin 2003)
[45] This presupposes a conflict of interest between the constituencies and their governments, rather than assuming that regulators (as parts of the government) have the automatic goal of general welfare regulation, which is in line with assumptions of the procedurealist school adopted by the Mattli and Woods framework.

Supply-Side Conditions

In their overview of the literature on the political economy of monetary relations, Broz and Frieden[46] argue that there are three sets factors that determine the emergence of international monetary systems: a) national policy choices, b) global economic factors and c) purposive relations among states. These factors can be extrapolated to advance the study of financial systems in general and international regulatory standards in particular. In that tenor, though the importance of domestic factors has received some attention by IPE scholars[47], the importance of the international strategic environment that hosted these efforts for regulatory convergence has not benefited from the same.

The strategic environment ranges between two ideal types, cooperation and coordination. Coordination in international monetary relations assumes a Pareto-improving Nash equilibrium in which "countries benefit from choosing the same […] regime, although there may be disagreement over which to choose."[48] In the case of financial regulation, there is consensus that international standards are needed to reduce systemic risk, however; the content and scope of these standards are a matter of debate. Articles on the drivers of policy diffusion have documented cases in which it is demonstrated that certain regulatory practices are imitated without any formal negotiations.[49] Nevertheless, unlike in monetary relations where inflation targeting and independent central banks have become the norm across the globe, the ample differences between regulatory structures and practices in financial regulation are obstacles to the

CEU eTD Collection

[46] (Broz and Frieden 2001, 335)
[47] (J. A. Frieden 1991, Singer 2004, Wood 2005)
[48] (Broz and Frieden 2001, 336)
[49] (Gandrud 2013, Simmons and Elkins 2004)

emergence of successful coordination patterns.[50] This has been mostly the case for global initiatives to converge macro prudential policies.

In the case of the Banking Union, it is necessary to build upon an assumption of a Pareto-inferior Nash equilibrium that requires constant bargaining to be maintained and improved on. Broz and Frieden[51] identify this as an environment of Cooperation in which the survival of the system depends on the existence of: a) a shared interest in stability from its core participants, b) linkage to other policies, c) the institutionalized nature of interstate cooperation and d) the environmental economic conditions. Whereas the global financial governance system is characterized by accountability, inclusion and institutional overlap deficiencies[52], efforts for setting international regulatory standards in the context of broad regional institutional frameworks need not face these challenges with the same degree of severity.

Along with the institutional framework of the EU and the shared interest in stability by the Eurozone Member States, there are other aspects of the international setting that shaped the design of the Banking Union. According to the international regulatory harmonization theory proposed by Andrew Singer[53], there are three types of international regulatory harmonization: a) regulatory convergence, b) core harmonization and c) peripheral harmonization. The first refers to a process in which countries seek to modify their regulatory standards to resemble those of others. The second refers to a process in which industrialized countries modify their regulations to comply with previously negotiated standards. Finally, peripheral harmonization occurs when countries outside of the core group decide to implement the standard or to actively diverge from

CEU eTD Collection

[50] (Mosley and Singer 2009)
[51] (Broz and Frieden 2001, 338-339)
[52] (Major 2012, Mosley and Singer 2009)
[53] (Singer 2004, 562)

it. Under the assumption of a strategic environment characterized by a Pareto-inferior Nash equilibrium, the members of the currency union have a strong interest in overcoming their conflicts of interest in order to achieve the common, and pressing, goal of stability. The Banking Union thus emerged as a process similar to the core harmonization proposed by Singer, but with the ameliorating factor of a broad institutional forum and a transparent process that set the proper incentives for the emergence of a satisfactory arrangement.

The structure of the international strategic environment described *supra* is a necessary but not sufficient condition for the emergence of the Banking Union arrangement. Tthe process is not automatic and there are numerous domestic factors that influenced the design and content of this next step in the economic integration process. This extensive institutional supply marks the proper conditions for the emergence of a common interest regulatory arrangement[54]. While this explains the genesis of the BU (the supply side conditions) it does not give an account of its design[55]. The design of the arrangement –and the main concern of this thesis– cannot be fully explained without exploring the structure of the demand side of financial reform in the Eurozone.

Demand-side conditions

In his classic *opus* on the study of economic crises "Politics in Hard Times", Peter Gourevitch argues that great crises open the door for great transformations. According to the author, economic policy during the *hard times* is follows a fundamentally different logic as that enacted during the *good times*. In times of crisis, pre-existing coalitions shift with the economic landscape

[54] (Mattli and Woods 2009)
[55] (Solingen 2008)

CEU eTD Collection

and new opportunities, and necessities, for change arise.[56] In 2013, Gourevitch revisited his argument to accommodate for the impact of the Great Recession, namely to study why coalitions against what he calls the regulatory financial complex failed to produce any significant policy changes.[57] According to the author, this failure can be explained by the relative decline of organized labor and the collapse of the great modern compromise.[58] Taking the United States as an example, Gourevtich concludes that "financial lobbies caused not only the bubble that led up to the current crisis but have greatly shaped the policy responses to it."[59] This is in line with the generally held notion, both in academia and public opinion, that the demand coalitions for stricter financial regulation face an uphill battle.

Nevertheless, explanations that focus on the asymmetries that societal actors that seek reform face, usually by stating the incentives they have to do so, overlook the supply side criteria. I argue that, in the case of the Banking Union, the favorable institutional environment (taken as exogenous) allowed for the emergence of the arrangement as a crisis management tool. Thus, both the political turmoil that followed the financial upheaval and the EU institutions that hosted the negotiations are *sine qua non* conditions that allow for the analysis of this next step in financial integration using the two-level game approach mentioned *supra*.

Though there is a wide variety of factors that explain the lack of a substantial overhaul of the global financial architecture in the aftermath of the Great Recession[60], my focus is limited to

[56] (Gourevitch 1986, 21)
[57] (Gourevitch 2013)
[58] A similar concept as the one used by Ruggie to explain the collapse of the post-war arrangements categorized as *embedded liberalism*, a process that was spearheaded by the retreat of the public sphere and erosion of social security apparatuses. (Ruggie 1982) According to Gourevitch (2013, 254), great modern compromise not only included welfare concessions but also a complex regulatory apparatus that capped the growth of large-scale financial institutions.
[59] (Gourevitch 2013, 225)
[60] (Major 2012, Goldstein and Véron 2011)

CEU eTD Collection

macro-prudential banking regulation in general, and its international dimension in particular. Financial policy is sticky due to high collective action costs and vast information asymmetries that arise from i) the low-salience of regulatory policy during times of growth and ii) the highly technical jargon of the industry which obfuscates the policy goals of coalitions for reform[61]. In order for these obstacles to be overcome, there must be enough incentives for societal actors to adopt the costs of collective action for general welfare regulatory reform; the sovereign debt crisis set the stage for the formation of a strong societal demand[62] for stricter regulations described below. This suggests that the Banking Union cannot be understood without taking into consideration its crisis management dimension.

After the financial collapse of the 2008 and the ensuing Euro crisis, public demand for increased regulation grew exponentially. The unpopularity of the bail-in mechanisms and of interregional transfers of fund to fight the crisis led raised the salience of financial regulation in the public opinion. Regardless of the many conflicting demands of constituencies across the Eurozone[63], there is consensus on the need for increased stability and oversight mechanisms intended to dilute the pernicious relationships that banks have with their regulators.[64] Likewise, though the issue of interregional transfers is a politically delicate subject, there is also a general demand for making the arrangements fiscally neutral, that is, that the costs of resolving failed financial institutions rest on the banks themselves and not on the taxpayers. These two elements – fiscal neutrality and increased accountability– shape the general "win-set" of the general public.

CEU eTD Collection

[61] (Lall 2012, Mattli and Woods 2009, Mosley and Singer 2009)

[62] Whether this demand can overcome these obstacles and prove to be sustained for a significant time period presents an interesting puzzle and would determine the long term *effects* (Solingen 2008) of the Banking Union; however, the scope of this thesis is limited to the explanation of the factors behind its *genesis* and *design*.

[63] Represented mostly as a conflict between Northern and Southern Europe (Howarth and Quaglia 2013)

[64] (Whyte 2012)

The "acceptability set" is a more complex calculation considering the vast array of interests involved in the process. Nevertheless, there are some commonalities across the board and that shape the general preferences of the CoG involved in the negotiations. The pressing issue of financial volatility and the possibility of an eventual break-up of the currency union are two of the main concerns. Regardless of its long-term economic effects, maintaining the Euro with its current membership has been proven to be a strongly held preference by the governments of the Eurozone Member States. In order to be within the boundaries of the "acceptability-set", the mechanism devised to address the societal demands of the "win-set" must also address the general issue of maintain cohesion in the Euro area.

The design of the Banking Union is therefore a function of its ability to reduce overall systemic risk (which could lead to the collapse of the currency union) but within the constraints of the demand for transparency and fiscal neutrality. It enhances systemic stability by addressing two risks that arise from the politically fragmented nature of the Eurozone: a) political risk, understood as the risk that domestic government would use their regulatory prerogatives to externalize the costs of rescuing the banks of their jurisdictions (and main sources of credit)[65] and b) by setting common procedures and a common fund for dealing with failed banks and discouraging bank runs and speculative attacks driven by the fear (or hope) or redenomination. The Single Resolution Mechanism addresses the political risk and moral risk that comes from banks being overseen by their most important clients[66] while the Single Resolution Mechanism

CEU eTD Collection

[65] (Kudrna and Gabor 2013)
[66] (Whyte 2012)

entails a common fund to wind-down failed institutions. All while addressing the societal demands for increased accountability and fiscal neutrality.[67]

In sum, the Banking Union, understood as an international arrangement to decrease systemic risk by targeting the sources of financial fragmentation in the Eurozone, was possible due to satisfactory demand and supply side conditions. On the supply side, the international strategic environment, characterized as Pareto-inferior Nash equilibrium, met the conditions[68] that enabled the emergence of an arrangement: namely the existence of the institutional framework of the EU. As for the demand side –and main focus of the thesis– the pursuit of a more stable currency union set the incentives for increased financial integration by reducing two sources fragmentation: political risk and moral hazard. The societal demand for increased stability took two forms: a) increased accountability and transparence and b) fiscal neutrality. The governments of Member States faced a delicate tradeoff between the (often conflicting) demands of their constituencies, the market conditions, and their own preferences for maintaining regulatory autonomy. While the EU institutional framework is sufficient to explain the genesis of the arrangement, the societal and market demands for increased stability were paramount for its design. Thus, the Banking Union for the Eurozone can be construed as the economically optimal policy choice that rested within the boundaries of the politically achievable.

CEU eTD Collection

[67] (Valiante 2014)

[68] i) Common interest in stability, ii) linkage to other policies, iii) highly developed regional institutions and iv) economic necessity for reform (Broz and Frieden 2001)

Chapter Two- Political and Financial Fragmentation in the Eurozone

In October 1970, the Werner group, led by the then prime minister of Luxembourg, set a three stage plan to achieve an Economic and Monetary Union (EMU). This was partially a response to the monetary instability of the end of the 1960s that would eventually lead to the collapse of the Bretton Woods system in 1973.[69] The increasingly fluctuating currencies of the period began to jeopardize the achievements of the customs union and common agricultural policy. While the stability of currencies was not a pressing concern during the Bretton Woods system, the possibility of flexible exchange rates made coordinated monetary policies a priority for European policy makers of the time.

Exchange rate stability within the European Union has been a relevant concern for policy makers ever since. With the currency union, the issue of exchange rate volatility was finally put to rest; however, concerns over how to deal with exogenous asymmetric shocks were not addressed at the time. These concerns have become more relevant in light of the sovereign debt crisis and have put to question the paradigm of the engodeneity of *Optimum Currency Areas* that shaped the design of the Euro.[70] The reaction to asymmetric shock, in this case a sudden shift int eh availability of credit, proved to be different across the board and resurfaced old concerns about the design of the currency union.

CEU eTD Collection

[69] (Eichengreen 2011)
[70] (Rey 2013, 108)

Financial Fragmentation

The purpose of this section is to explore the relationship between political and financial fragmentation, I argue that the former is a cause of the latter. Evidence to demonstrate the increase in financial fragmentation after the 2008-2009 sovereign debt crisis is presented by illustrating the process of financial convergence/divergence patterns in the Eurozone for the 2001-2012 period. The two independent variables are the Long-Term (10 year) Interest Rates and the Eurozone Bond Yields for both 10 and 1 year sovereign bonds. The general hypothesis is that the Eurozone debt crisis changed market behavior as it made the underlying political and redenomination risks evident.

H_1: There is a statistically significant difference between market trends towards euro-denominated central government debt before and after the 2008-2009 crisis.

H_0: There is no statistically significant difference between market trends towards euro-denominated central government debt before and after the 2008-2009 crisis.

Long Term Interest Rates

Long term interest rates are a vital financial indicator, they show the degree of risk aversion/appetite that markets have, as well as their future calculations on the soundness of a long-term investment. Under normal conditions, interest rates on any asset are directly proportional to its risk of default. Though their utility as monetary policy tools is a matter of debate[71], their fluctuation is a useful indicator of the overall volatility and market sentiments. In this section, the monthly average interest rates for long-term government bonds calculated by the

[71] (Turner 2013)

CEU eTD Collection

European Central Bank (ECB) are considered.[72] It is expected that a clear pattern of convergence-divergence will be apparent in the Eurozone group with no similar pattern for the Non Eurozone countries. For this purpose, the following hypotheses are tested:

Hypothesis A_1: There is a statistically significant difference between the Eurozone and Non Eurozone means.

Hypothesis 0_1: There is no difference between the two groups. (Eurozone and Non Eurozone)

Hypothesis A_2: There is a statistically significant difference between the pre-crisis and post-crisis means for the Eurozone.

Hypothesis 0_2: There is no difference between the two groups. (pre-crisis and post-crisis)

The data collected from the ECB for the average yearly interest rates of the European Union members suggests that, for the 2001-2012 period, there is little difference between the means of the Eurozone and Non Eurozone interest rates. The tables below show that the difference between the average interest rate for both groups is less than 1 percentage point and that the standard deviation is also similar. However, the difference between the ranges of both groups suggests that both groups are not similarly clustered around the mean.

Table 1

Long-term interest rates for the 2001-2012 period

	Eurozone	Non-Eurozone
Average	4.7	5.34
Standard Deviation	2.06	1.92568957

[72] This section is based on an unpublished paper submitted by the author to the Department of International Relations and European Studies at the Central European University (2014) (European Central Bank 2014)

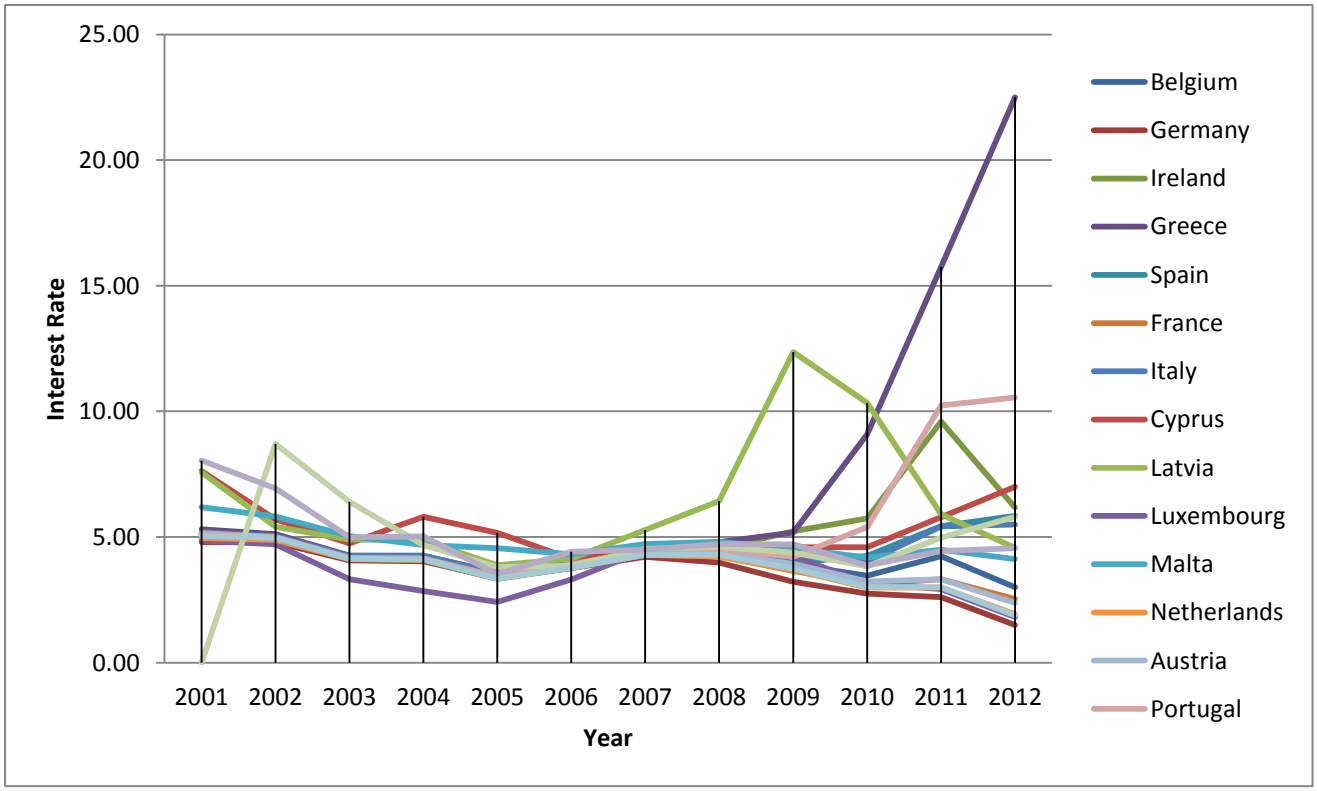
CEU eTD Collection

Range	21	12.6

Source: European Central Bank. Long-term interest rate statistics for EU Member States. (2014)[73]

A deeper insight can be drawn from the graphs presented below. Graph 1 displays the annual average interest rates for Eurozone countries for the 2001-12 period. With the exception of Latvia, interest rates within the group followed a path of convergence until 2008. The initial path of divergence begins in 2008 and continues throughout 2012, with some countries experiencing a sustained decrease in long term interest rates (Germany, Austria, Netherlands) and some a dramatic increase (Greece, Portugal, Ireland).

Graph 1: Long Term Interest Rates for Eurozone Members (2001-2012)



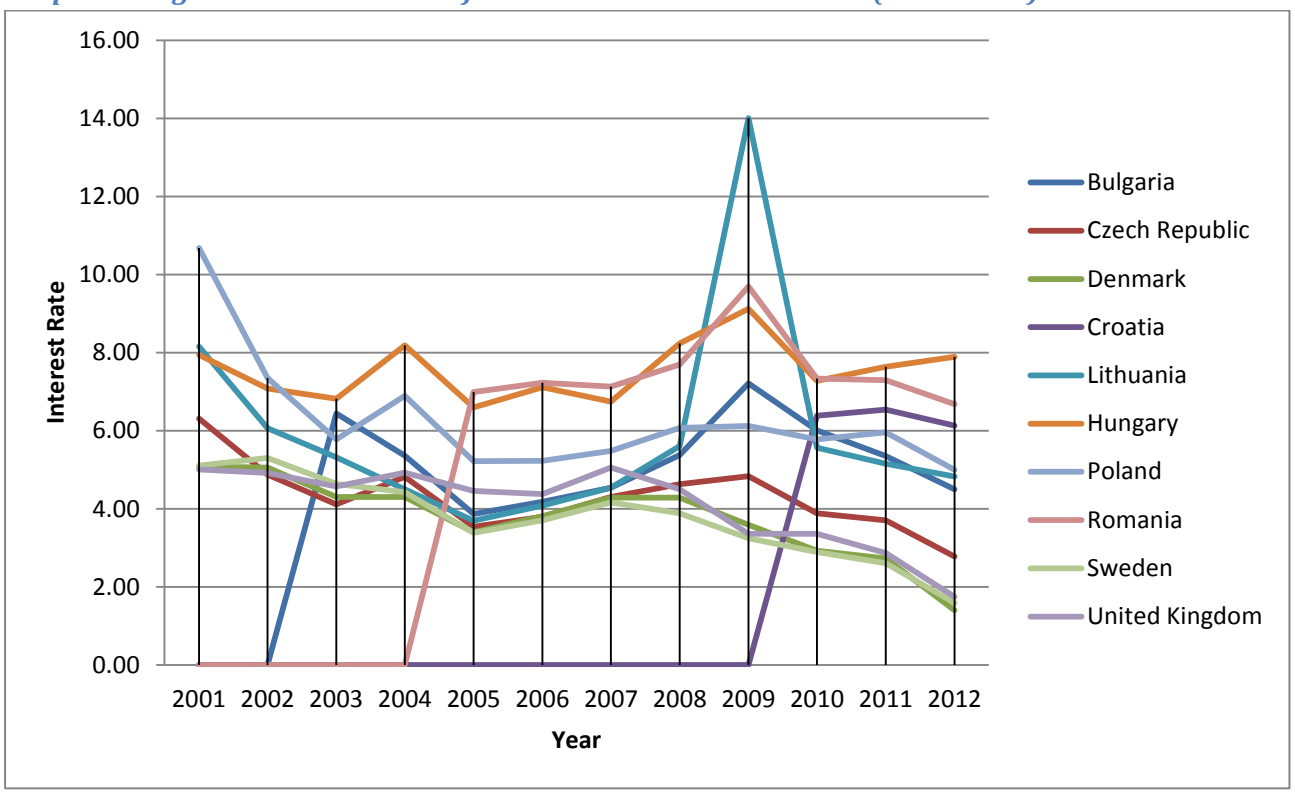
Source: European Central Bank. Long-term interest rate statistics for EU Member States. (2014)

[73] The data was obtained from the monthly average interest rates published by the ECB, the figures presented in this database are constructed by taking the yearly average from the ECB database for the 200-2012 periods and the four year data is the simple average of the interest rates in the corresponding period.

CEU eTD Collection

Though there a clearly observable trends in Eurozone interest rates, convergence/divergence, this is pattern is not mirrored in Non-Eurozone countries (see Graph 2). Throughout the 2001-12 period, there are numerous spikes in the average annual interest rates and no clear trend of convergence or divergence. This can be explained by the fact that the countries in the group have kept their prerogatives for an independent monetary policy and thus are not expected to follow patterns of convergence, as is the case for Eurozone countries.

Graph 2: Long Term Interest Rates for Non-Eurozone EU Members (2001-2012)



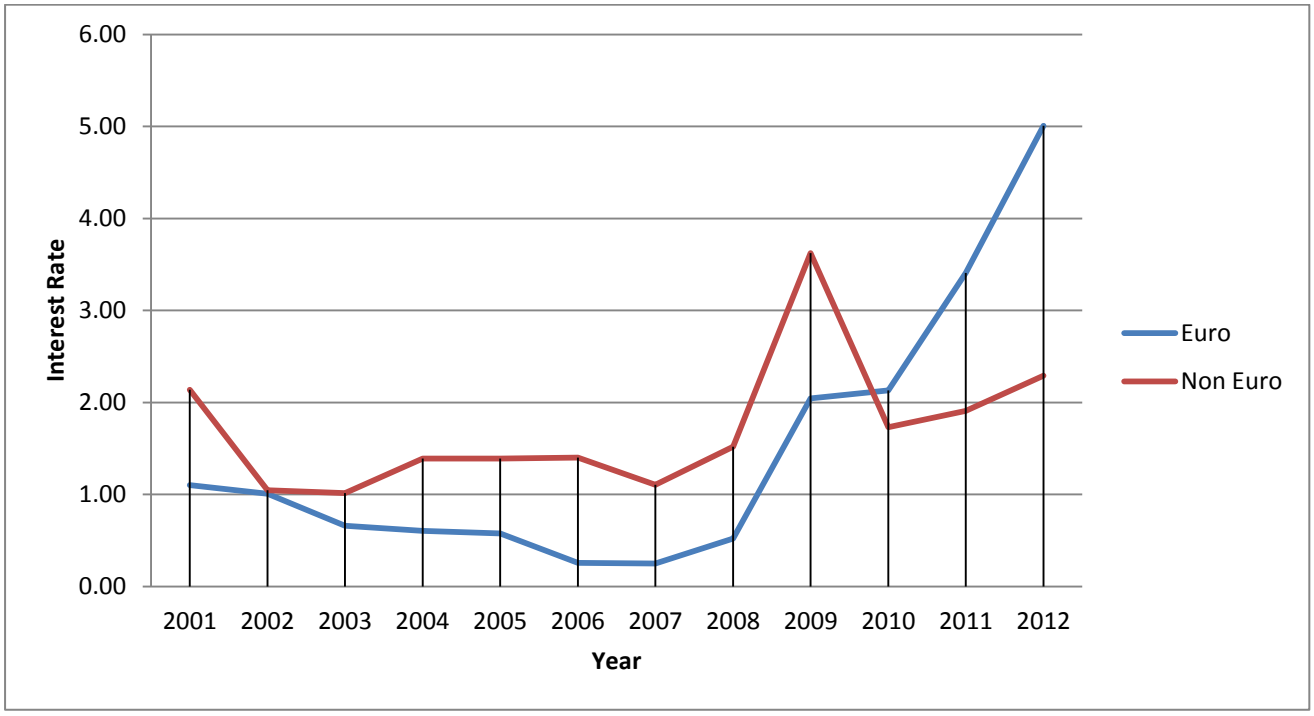
Source: European Central Bank. Long-term interest rate statistics for EU Member States. (2014)

The difference between the interest rate dispersion patterns can be more easily observed in the annual standard deviations across groups (Eurozone and Non Eurozone) displayed in

CEU eTD Collection

Graph 3. Long-term interest rates outside of the Eurozone oscillate between 1 and 2 points with the exception of 2009 (which can be attributed to increased uncertainty deriving from the financial crisis). This contrasts with the clear trends in Eurozone countries where prior to 2008 there was an observable asymptotic behavior that was reversed after the crisis. The shift from a negative slope prior to 2008 to a positive one indicates that there was a significantly increased dispersion of the data-points in the Eurozone.

Graph 3: Long Term Interest Rates Standard Deviations for all EU Members (2001-2012)



Source: European Central Bank. Long-term interest rate statistics for EU Member States. (2014)

In sum, neither of the alternative hypotheses presented supra can be discarded. Though in both cases there was an exogenous shock to the availability of credit, the two groups responded differently. By controlling for EU membership in interest rate volatility, it can be construed that there is a pattern that is specific to the condition of the Eurozone.

CEU eTD Collection

II.

The purpose of this sub-section is to determine whether country-specific risks played a part in the divergence of long-term interest rates within the Eurozone. It is expected that the lower confidence in the macroeconomic stability of Southern and Eastern European members of the Eurozone would manifest in a statistically significant with respect to the long-term interest rates in Western Europe, with the latter having lower rates. Though there are numerous regional nuances, for the purposes of this paper the groups are constructed as follows: Western Europe (Belgium, Germany, France, Luxembourg, Netherlands, Austria and Finland), Southern Europe (Ireland, Greece, Spain, Italy, Cyprus and Portugal) and Central and Eastern Europe (CEE) (Latvia, Slovenia, Slovakia). The following hypotheses are put to the test:

Hypothesis A_3: There is a statistically significant difference between the annual long-term interest rate means of Western Europe and Southern & CEE in the 2008-2012 period.

Hypothesis 0_3: There is no statistically significant difference between the annual long-term interest rate means of Western Europe and Southern & CEE in the 2008-2012 period.

The data collected from the ECB indicates that, for the post-crisis period, there is a statistically significant difference between the means of both groups. For Western Europe, long term interest rates decreased to below Eurozone average for the 2001-2012 period by more than 1.1 percentage points (see Table 1). Table 4 indicates that the opposite trend was true for CEE & Southern Europe, with an increase of 1.4 points over the 2001-2012 Eurozone average. Similarly, the difference between the means of both groups for the post crisis period is 2.81 percentage points.

CEU eTD Collection

Table 2

Eurozone Long-term interest rates for the 2008-2012 period

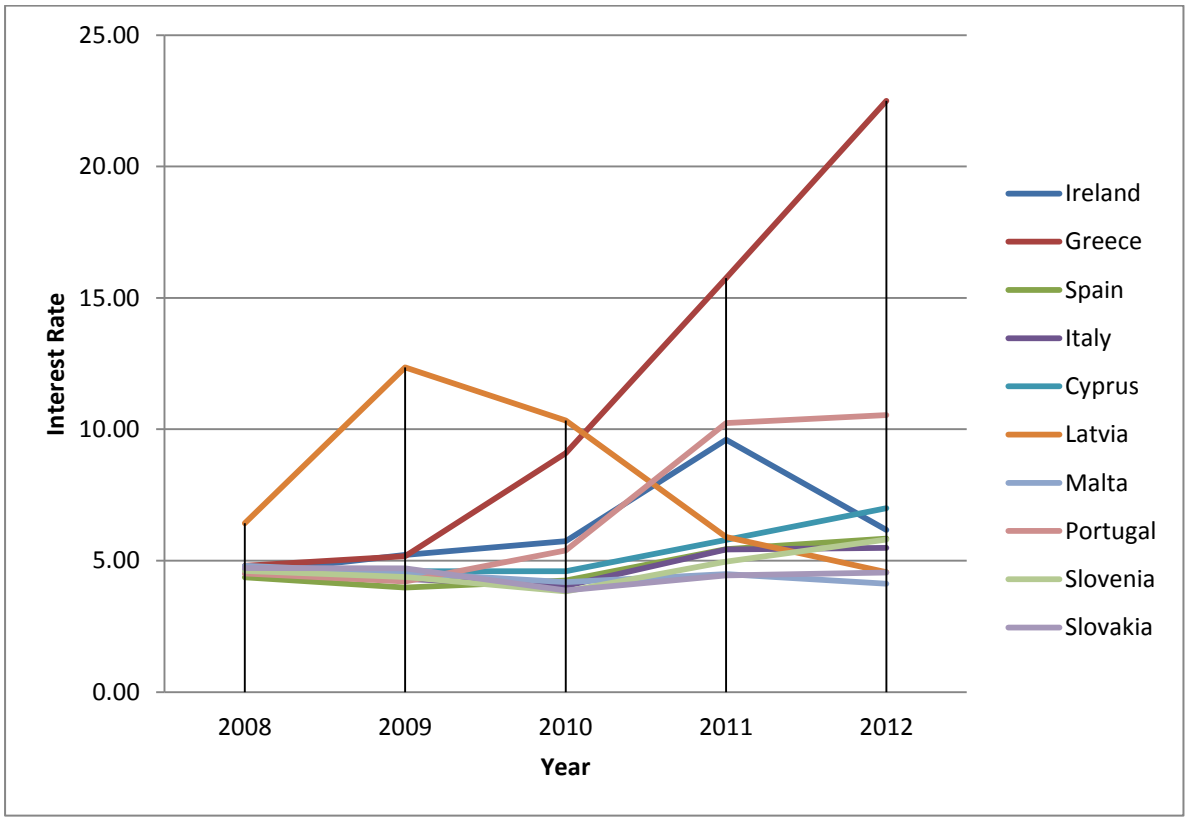
	Western Europe	Central, Eastern and Southern Europe
Average	3.3	6.11
Standard Deviation	0.812552	3.38512415
Range	4.61	22.5

Source: European Central Bank. Long-term interest rate statistics for EU Member States. (2014)

Tables 3 and 4 also indicate that the data for Western Europe is more closely clustered around the mean with a range of 4.61 points. Conversely, the data for Southern and CEE is much less clustered, as shown by the significantly higher range (22.5 points for the period) and a standard deviation more than 3 times higher than in Western Europe. Graph 4 shows the trends for Southern and CEE in more detail for the post-crisis period. Ireland, Greece, Portugal and Latvia show a higher degree of volatility with most of the other countries having positive slopes.

CEU eTD Collection

Graph 4: Long Term Interest Rates Central, Eastern and Southern Europe (2008-2012)



Source: European Central Bank. Long-term interest rate statistics for EU Member States. (2014)

In sum, H_3 cannot be discarded as there is evidence of a statistically significant difference between the means of the two groups. Likewise, the initial assumption on the vector of these differences is also empirically sustained. Therefore, it can be concluded that the Eurozone members that are not a part of Western Europe had a different response to the crisis than did their counterparts. It can also be concluded that the long-term interest rate patterns of the Eurozone differ from those of non-Eurozone countries both in the pre and post crisis periods. The absence of a pattern in non-Eurozone countries supports the claim that the 2008 financial crisis surfaced underlying risks within the Eurozone that do not respond to a shared shock absorption across the board. Furthermore, the evidence presented in this case study also supports the broader claim that political fragmentation leads to financial fragmentation, evidenced by a correlation between post-

CEU eTD Collection

crisis interest rate volatility and macroeconomic instability (real or perceived) within the Eurozone.

Bond Yields

The ECB calculates the yield curve data for the Eurozone by representing the relationship between the remuneration in the secondary markets *vis. a vis.* the lapse to maturity of the sovereign debt issued by member states. The data represents how investors react to shifting market conditions by adjusting their inflationary, future interest rate and default risk expectations. The ECB also considers the differences between the AAA and non AAA (All) rated government bonds by using data from Fitch Rating.[74] Likewise, the database is constructed by using zero-coupon hypothetical yields[75] for all Eurozone central government debt.

Under normal circumstances, the yield curve presupposes returns as inversely proportional to the time to maturity. That is, bonds with lower maturity times (1 year) are expected to have lower yields than bonds with higher maturity rates (10 year). The logic behind this assumption is that investor calculations take into account both liquidity requirements and inflationary expectations over short and long periods; as it is theoretically riskier to make long-term investments due to uncertainty over inflationary and interest rates (or overall monetary policy) over a longer period of time.

The dataset used for this section is constructed by taking the annual simple arithmetic average of the spot daily spot yields calculated by the ECB for the periods from 2005 to 2012. As

[74] (European Central Bank 2014)

[75] This means that the ECB estimates the bonds as hypothetically sold at discount and the par yield is also a hypothetical estimation. (European Central Bank 2014)

CEU eTD Collection

in the previous section, the financial fragmentation of the Eurozone as a function of the 2008 sovereign debt crisis presupposes a trend of convergence of AAA and All bond yields for the 2005-2008 period followed by a divergence pattern for the 2009-2012 period. Likewise, it is expected that in times of crisis the yield curve would shift away from the normal pattern, making short term investments less attractive. Table 3 shows the data averages gathered from the ECB data and with which the Hypothesis of this section are tested.

Table 3

Arithmetic Average Yield Curve Data for the Eurozone: Spot Rates per Annum

	Average				Standard Deviation			
Year	**AAA 1Y**	**All 1Y**	**AAA 10Y**	**ALL 10Y**	**AAA 1Y**	**All 1Y**	**AAA 10Y**	**ALL 10Y**
2005	2.209083918	2.211057556	3.440813148	3.402599198	0.187322168	0.185054929	0.178860666	0.184078997
2006	3.222078596	3.228369973	3.809557522	3.757214	0.324830231	0.326030471	0.210528526	0.208746884
2007	3.992391827	4.001692475	4.281424729	4.230242882	0.15932512	0.156403519	0.195556651	0.194074042
2008	3.611215227	3.644023926	4.372856066	4.248205191	0.733910045	0.702853979	0.250156815	0.268582222
2009	0.91394157	1.003166352	4.044873027	3.820908402	0.213302195	0.23805885	0.170374664	0.154873642
2010	0.593462221	0.939871829	3.739978674	3.150766101	0.138938079	0.224218027	0.184192903	0.348784657
2011	0.903913868	1.979668693	4.272359763	3.14979472	0.399567004	0.472940659	0.202647937	0.390501493
2012	0.050760699	1.273252547	3.650353957	2.197608293	0.094678119	0.390950478	0.331612113	0.337678948

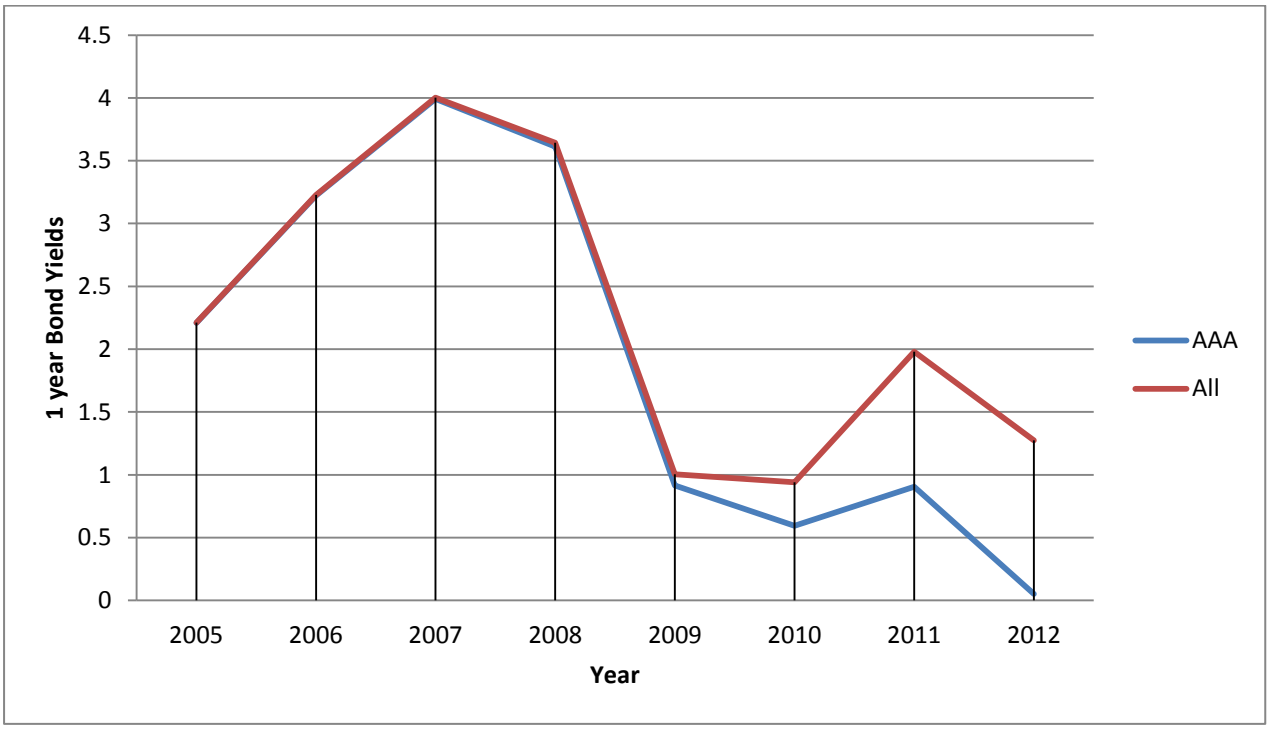
Source: European Central Bank. Euro area yield curve. (2014)

Hypothesis B_1: There is a statistically significant difference between the pre-crisis (2005-2008) and post-crisis (2009-2012) means 1 year spot sovereign bond yields per annum.

Hypothesis 0_1: There is no statistically significant difference between the pre-crisis (2005-2008) and post-crisis (2009-2012) means 1 year spot sovereign bond yields per annum.

CEU eTD Collection

Graph 5: Average AAA and All Bond Spot Yields Per Annum (1 year maturities)



Source: European Central Bank. Euro area yield curve. (2014)

Graph 5 shows a clear change in the yield trends for AAA and All after 2009. The yield for AAA bonds continued the decline that begun in 2007 to reach almost zero in 2012. However, the case was different for the rest.[76] The data suggests that yields for non-AAA bonds were raised significantly both in absolute and relative (to their AAA counterparts) terms after the Eurozone crisis. Regardless of the reasons for this trend –which are beyond the scope of this paper– the conclusion that can be drawn is that, after a five year period of treating the sovereign debt of all

[76] The variable "All" includes both the AAA group of sovereign bonds and the rest of the debt issued by Eurozone central governments. This means that the grouping of exclusively non-AAA bonds is unavailable and would likely reflect and even greater pattern of divergence in the annual means calculated in this thesis. Nevertheless, the data presented here shows a divergence significant enough to be able to tease out the differences in overall trends. Likewise, the data does not show which bonds, either in nominal terms or as a percentage of the data set, are considered to be AAA or non-AAA throughout the studied period. This is also a source of possible distortions as the number of non-AAA bonds is expected to raise after the crisis. However, this fact does not contradict the overall tenet that the Eurozone became increasingly fragmented after the crisis. Thus, if it is a matter of rating or of general market behavior towards Euro-denominated securities, the conclusions regarding the fragmentation (though not the causes behind the trends) remain valid.

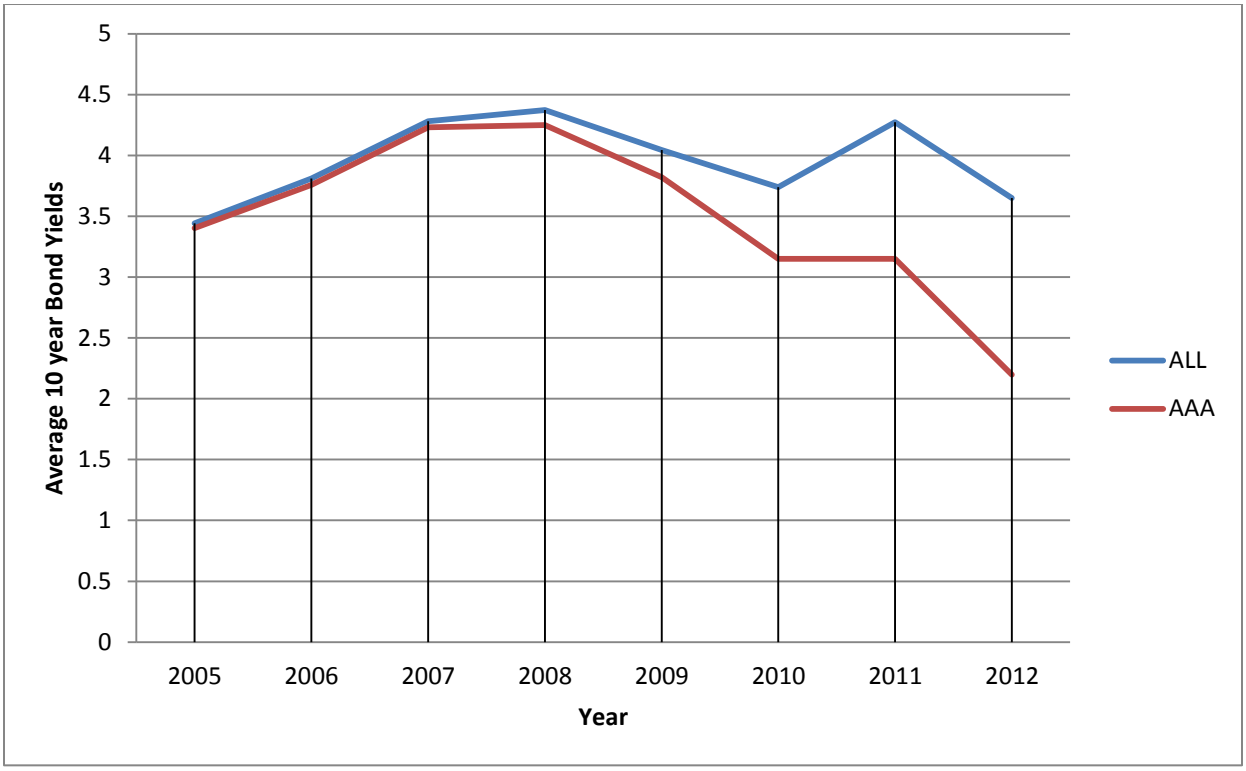
CEU eTD Collection

Eurozone countries (for 1 year bonds), markets began to discriminate between AAA and non-AAA government bonds after the crisis. Thus, it is not possible to discard Hypothesis B_1.

Hypothesis B_2: There is a statistically significant difference between the pre-crisis (2005-2008) and post-crisis (2009-2012) means 10 year spot sovereign bond yields per annum.

Hypothesis 0_2: There is no statistically significant difference between the pre-crisis (2005-2008) and post-crisis (2009-2012) means 10 year spot sovereign bond yields per annum.

Graph 6: Average AAA and All Bond Spot Yields Per Annum (1 year maturities)



Source: European Central Bank. Euro area yield curve. (2014)

Graph 6 shows the trends in government bond yields for the 2005-20012 period but for 10 year maturity bonds. A similar trend as with the 1 year bond can be observed here, a pattern of convergence followed by a pattern of divergence after 2008. This supports the overall hypothesis

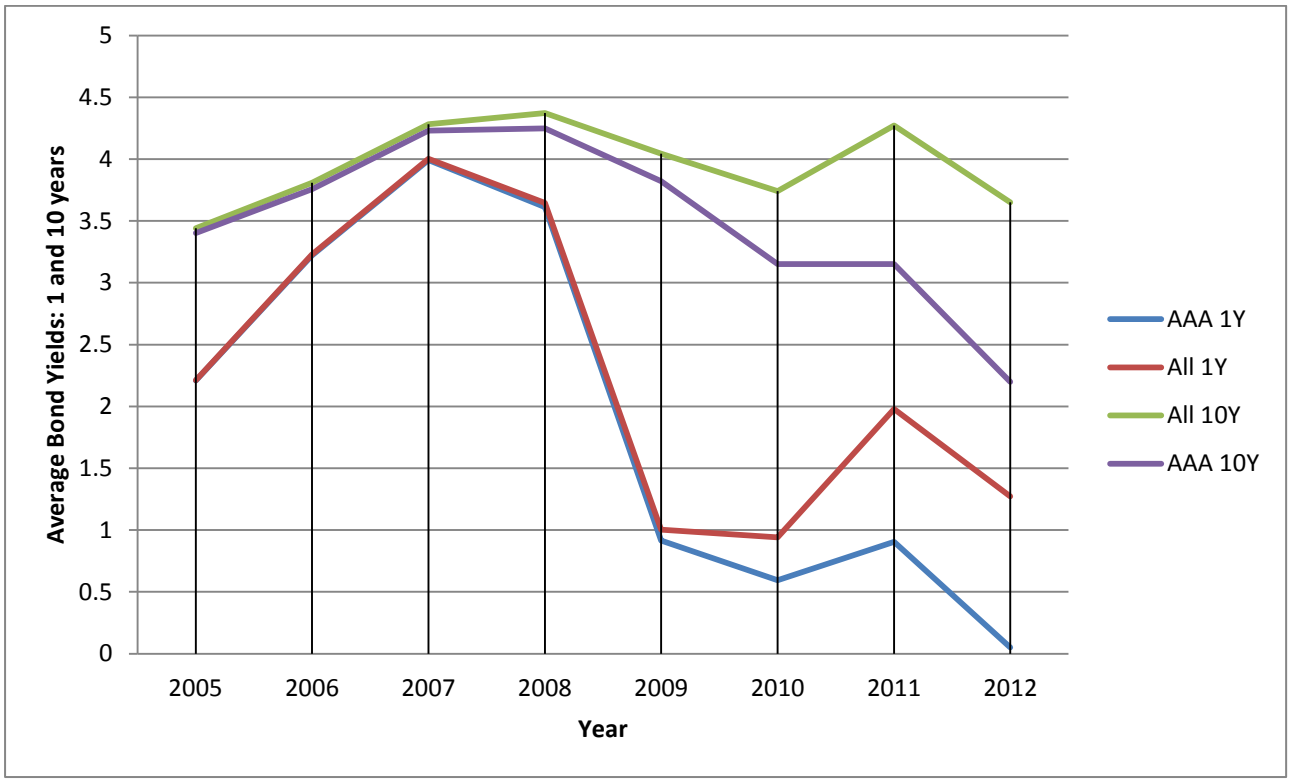
CEU eTD Collection

that the Eurozone bond market became increasingly fragmented after the crisis as investors began to shift their calculations away from considering all Euro-denominated as equal to discriminating based upon their rating. The data indicated that the alternative hypothesis cannot be rejected as there is sufficient evident to support the expected pattern of convergence/divergence in bond yields throughout the studied period.

Hypothesis B_3: The yield curve for the 2005-2012 period for 1 year and 10 year bonds does not reflect a normal distribution (in which yields are directly proportional to maturity).

Hypothesis 0_3: The yield curve for the 2005-2012 period for 1 year and 10 year bonds reflects a normal distribution (in which yields are directly proportional to maturity).

Graph 7: AAA and All Bond Yields in Comparison (1 and 10 year maturities)



Source: European Central Bank. Euro area yield curve. (2014)

CEU eTD Collection

Finally, Graph 7 shows that the yield curve for the overall period and for both AAA and All sovereign debt in the Eurozone has a normal distribution. That is, bonds with longer maturities have higher yields for the entire period. Despite a trend of convergence in the 2005-2007 period (which would have resulted in a flat yield curve) the spot rates for 10 year bonds do not touch or are surpassed by the 1 year bonds. This presupposes normal market behavior in the sovereign debt market and suggests that the null hypothesis cannot be rejected.

In conclusion, all of the supporting alternative hypotheses have been proven plausible, thus making it impossible to discard general alternative hypothesis[77]. The data presented in this section presents evidence that supports the claim that market actors began treating euro-denominated bonds differently after the crisis.[78] It can be confirmed that, regardless of the factors that influenced the yields, the Eurozone became more fragmented after 2008: a general pattern of convergence followed by divergence. This means that there is sufficient evidence to claim a correlation between the fragmentation of the Eurozone sovereign debt market and the crisis. Likewise, it can be argued that this is a result, at least in part, of the increased political and redenomination risks that are a result of the political fragmentation in the currency union.

Political Fragmentation

CEU eTD Collection

[77] *There is a statistically significant difference between market trends towards euro-denominated central government debt before and after the 2008-2009 crisis.*(see *supra*)

[78] Though it can be inferred that after the crisis ratings became a more important factor in determining yields, further research is required to be able to make that statement; alas, ratings are considered in this paper as a mere proxy for market perceptions on the possibility of default of each country as a product of their take on the sustainability of the macroeconomic policies pursued by the central government. Whether these calculations on the sustainability of the macroeconomic policies of the European periphery respond to mathematical models or to the Keynesian notion of "animal spirits" is, once again, well beyond the scope of this thesis.

There is a multiplicity of country-specific risks that prevail in spite of a currency union. The fact that the Eurozone remains fragmented politically causes distortions in the financial system and increases overall risk. This political fragmentation is due to the fact that, though the members of the Eurozone have yielded monetary policy prerogatives to the ECB, they still have control over regulatory and taxation policies that do not directly contravene EU treaties.[79] Therefore, in the face of an exogenous shift in the availability of credit, it is up to the individual units to decide how the losses are to be allocated among depositors, shareholders and creditors. This fragmentation serves as a catalyzer for country-specific risks at the systemic level. Concerns over redenomination or the arbitrary usage of regulatory prerogatives that are enabled by political fragmentation translate into financial fragmentation and increased systemic instability. These underlying risks are a function of a design flaw in the currency union and have caused markets to change their once homogenous calculations on euro-denominated government securities.

Redenomination risk arises when markets begin to question the irreversibility of a currency union[80]. The unsustainability of macroeconomic policies of member states, or market views on such, is a key factor that leads to a generalized loss of confidence in the cohesion of such a union. The dismemberment of a currency union would entail not only the flight of portfolio capital but also have distributional effects on long-term investors, depositors and the domestic financial system in general. In the case of the Eurozone, if a member were to exit the currency union and adopt its own currency, or redenominate, then the contracts and obligations payable in Euros could either continue to be denominated as such, or in the new currency.

CEU eTD Collection

[79] (Valiante 2014, Kudrna and Gabor 2013)
[80] (Elliot 2012, Véron 2013)

If a country in crisis is forced, by circumstances or mandate, to exit the currency union, it is likely that its new currency would have a parity adjustment directly proportional to the severity of its economic state of upheaval. If such a country is running an unsustainable deficit, a likely scenario, then its new currency would suffer an almost immediate devaluation in order to adjust the macroeconomic imbalances.

As for political risk, it can manifest in non-catastrophic forms –as opposed to the cataclysms or arbitrary practices often associated with it– such as taxation and regulation policy that are economically relevant but often overlooked.[81] The risk of arbitrary distribution of losses among stakeholders in the aftermath of the financial meltdown raises the salience of political risk. These risks, along with exchange-rates, capital flows and fiscal policies comprise a set of country risks that are difficult to predict. In cases where a sector is primarily dominated by foreign stakeholders, such as the financial sector, the costs of modifying sectoral and taxation policies are low for regulators.

Thus, crises create short-term incentives to place the burden of adjustment disproportionately on foreign entities. The time inconsistencies between economic and political cycles exacerbate these risks. In the case of the EU, the treaties give a large amount of leeway to members to enact independent taxation and regulatory policies insofar as they do not directly contravene the treaties.[82] This combined with diverging macroeconomic policies among Eurozone member states resulted in the fragmentation of the sovereign debt markets.

CEU eTD Collection

[81] (Kudrna and Gabor 2013)

[82] The Maastricht Treaty stipulates that Member States are to facilitate the coordination of economic policies by way of multilateral supervision and subject to the principles of fiscal and financial discipline. The Economic and Monetary Union (EMU) was designed as a way to ensure the creation of a single currency in a three stage process: a) the liberalization of capital movements (1990), b) the convergence of economic policies (1994) and c) a single currency and common central bank (1999). (European Commission 2014)

In conclusion, it has been demonstrated that there was an increase in the fragmentation of the euro-denominated sovereign debt market in the long-term, the short-term as well as in primary and secondary markets after the onset of the debt crisis in the Eurozone. It has likewise been argued that this change in trend, from convergence to divergence, can be explained in part due to the political fragmentation of the currency union. In other words, the leeway for regulatory discretion coupled with distinct macroeconomic policy measures across the board surfaced the underlying differences between risks of default and political risks for Member States. Thus, market actors took corrective measures by adjusting their calculations on euro-denominated sovereigns, which in turn resulted in diverging yield and interest rate trends. With this in mind, policy makers took corrective actions by homogenizing crisis management procedures through the Banking Union.

CEU eTD Collection

Chapter Three- The Banking Union: Distortions, Transparency and Fiscal Neutrality

The EU banking sector has grown increasingly integrated due, greatly in part, to the single currency and less restrictions on cross-border activities. The decreased transaction costs within the Eurozone have set the environment for a steady increase in financial activities within the region. Nevertheless, the 2008 crisis made some of the vulnerabilities and inadequacies of the monetary union evident in a world of highly interdependent capital markets. The lack of coordination in regulatory policies before and after the crisis has resulted in market distortions and increased volatility. The financial legislation of the EU consists mostly of directives that contain ample space for national discretion[83]. This national discretion in the scope and enforcement of financial regulation creates distortions, particularly in cases of crisis.

The Banking Union proposal is an effort to completing the currency union and to prevent future financial crises from spreading throughout the area or from arising altogether by strengthening the banking sector.[84] The European Commission proposed five pillars: a) a single supervisory mechanism, b) a single rulebook, c) a common deposit guarantee scheme, d) a resolution mechanism and e) a fiscal backstop.[85] These pillars are intended to eliminate the vulnerabilities that caused the negative spill-over effect that characterized the 2008 financial crisis in Europe.

CEU eTD Collection

[83] (Howarth and Quaglia 2013, 107)

[84] This section is based on an unpublished paper submitted by the author to the Department of International Relations and European Studies at the Central European University (2014)

[85] Though the proposal has only 4 pillars, the common fiscal backstop is one of the most contentious points as it would effectively determine where the money for the deposit guarantee or possible bail-outs come from.

The crisis taught two important lessons; that there is a need for greater oversight and accountability in banking supervision across the board and that the bail-out scheme is a politically unacceptable measure. The Banking Union thus seeks to correct the market distortions identified in the previous chapter by eroding domestic regulatory arbitrariness and by taking the public demands for transparency and fiscal neutrality into consideration. The result of these factors led to the approval of a series of legislations that are detailed throughout this section.

Figure 3.1

The Banking Union Process	
September 12th, 2012	The Commission proposes the Single Supervisory Mechanism (SSM) to be led by the European Central Bank. It also proposes the outline for the Banking Union and its five pillars.
March 19th, 2013	The European Parliament (EP) and the Council reach a political agreement on the content of the SSM proposal.
July 10th, 2013	The European Commission proposes a Single Resolution Mechanism (SRM) to complement the SSM and the Banking Union.
September 12th, 2013	The EP votes on the SSM and approves it.
October 29th, 2013	The transfer of supervisory powers to the ECB and the modification of the EBA regulation are published in the Official Journal.
March 20th, 2014	The EP and the Council reach a political agreement on the SRM proposal.
April 15th, 2014	The EP approves the SRM proposal as well as the Bank Recovery and Resolution Directive (BRRD: proposed 2012) and the Deposit Guarantee Schemes (DGS: proposed 2010)
January 1st, 2016	The SRM regulation enters into force after a period of 1 year of cooperation between national authorities and the Resolution Board to ease the transition.
January 1st, 2024	The transition period ends and the common Resolution Fund is to be fully mutualized

Source: European Commission

CEU eTD Collection

The Single Supervisory Mechanism

On September 2012 2012, the European Commission proposed the Single Supervisory Mechanism (SSM) as a means to strengthen the currency union. The proposal included two elements: a) a transfer of supervisory responsibilities from National authorities to the European Central Bank (ECB) and b) the development of a Single Supervisory Handbook by the European Banking Authority (EBA) which would serve to harmonize regulations for all the EU members. The first one was intended to strengthen the Eurozone while the latter looked to strengthen the single market as a whole.[86]

The purpose of SSM is to restore market confidence in the stability of the Eurozone banks. The underlying logic behind the mechanism is that by removing direct supervision responsibilities from the national authorities the vicious link between them and the banks they regulate would be broken. The expected outcome is that private losses will not be borne by the tax payers during hard times.

Banks are normally heavily exposed to the sovereign debt of their national governments; this means that they are sensitive to volatility of the interest rate and government bond yields. However; it also means that they are a primary source of finance for their national governments. This generates a conflict of interests and an accountability problem, an element highly regarded as one of the main causes of the crisis given that national authorities are usually less than eager to impose heavy losses on their primary source of credit.[87]

CEU eTD Collection

[86] (European Commission 2012)
[87] (Whyte 2012)

On October, 2013, the European Parliament voted on the SSM and approved its adoption by the European Union. The approved legislative package containts two elements: a) a Council regulation that allows the transfer of supervisory prerogatives to the ECB and b) a modification to the existing regulation on the European Banking Authority (EBA) to adapt to the modified supervisory framework.[88] All of the Eurozone banks, approximately 6,000, will be subject to the SSM. Though it was initially proposed that only systemically important banks be a part of the mechanism, it was later acknowledged that "integrated supervision is necessary to make sure that all euro-countries can have full confidence in the quality and impartiality of banking supervision, opening the way for the European Stability Mechanism (ESM) to directly recapitalize banks that fail to raise capital on the markets."[89] However, due to the large amount of banks and limited supervisory capabilities of the ECB, the daily supervision tasks will still rest on national authorities while direct ECB oversight will be limited to those banks that enter within any of the following criteria: a) assets worth over 30 billion euros, b) assets worth over 20% of a country's GDP or c) having received assistance from the European Financial Stability Facility (EFSF) or the European Stability Mechanism (ESM).[90]

Though it will only be tasked with the direct oversight of systemically important credit institutions, under the new arrangement, the ECB has the option of directly supervising any given bank within the Eurozone in order to ensure the prevalence of the regulatory standards or upon request by the ESM. National supervisors must comply with the directives given by the ECB and give notice on "supervisory decisions of material consequence."[91] Among the responsibilities that

CEU eTD Collection

[88] (European Comission 2013)
[89] (European Commission 2012)
[90] (European Commission 2013)
[91] Ibid.

would be transferred to the European level were: a) authorization of credit institutions, b) capital, leverage and liquidity requirements, and c) financial conglomerate supervision.

The SSM was widely viewed as a prerequisite for future access to public assistance for banks. The lack of accountability and transparency that national regulators have for taxpayers abroad was one of the mayor arguments against the rescue packages and write-downs for troubled banks and governments. Though it does not help solve the problem at hand, the legacy debt that was contracted during times of lax oversight, the SSM is intended to make mutualisation easier for future distress seeing as the blame for supervisory errors would rest at the European and not the domestic level.

The Single Resolution Mechanism

The Single Resolution Mechanism (SRM) sets clear and uniform rules on how to resolve failed banks. The underlying premise is that if national authorities retain the prerogative of allocating losses for insolvent financial institutions the negative feedback loops between sovereigns and banks will not be broken (even if supervisory responsibilities are at the European level). The ultimate goal of this is to prevent taxpayers from assuming the burden of resolving banks.

The SRM and the complementary Bank Recovery and Resolution Directive (BRRD) state that the costs of resolution must first be borne by both creditors and shareholders as a prerequisite for public assistance. Once this step has been completed, and in case further assistance is still required for the troubled institution, then the costs of resolution can be drawn from the Single Bank Resolution Fund (SBRF), which is to be created from ex-ante contributions levied on the

CEU eTD Collection

banking sector. The European Council states that the SBRF is not to drawn upon the existing national resolution funds but rather is to be built up gradually.[92]

> This agreement, in line with terms of reference also approved today, would include arrangements for the transfer of national contributions to the fund and their progressive mutualisation over a 10-year transitional phase. It would endorse the bail-in rules established in the bank recovery and resolution directive as applicable to the use of the single fund.[93]

The idea of establishing a resolution fund with resources extracted from the banks themselves is in line with the EU's main preoccupation, avoiding widespread taxpayer bail-outs for what they perceive to be the errors of domestic regulatory authorities. In other words, transfers from citizens in financial stable countries to unstable banking sectors abroad over which they have no means to hold them accountable for their mistakes.

One of the main points of contention during negotiations with the European Parliament was the burden placed on the taxpayers during the bail-outs of the financial crisis. The guideline of the SBRF is fiscal neutrality, that is, that the taxpayer will not be expected to contribute in any way to the capitalization of the fund. As opposed to the SSM, the SRM requires a large amount of capital in order to credibly preform its tasks. Thus there is a transition period of 8 years after the SRM comes into effect fully in 2016. In the meantime, the agreement stipulates that the Fund can borrow on its expected tax levies on the banking sector up until the point of full mutualisation in 2024. The Directive on Bank Recovery and Resolution (BRRD) that was part of the approved legislative package to complement the SRM and to ensure that banking resolution is handled based on the principle of bail-ins until the SBRF is fully funded.

CEU eTD Collection

[92] (European Commission 2013)
[93] (Council of the European Union 2013)

The scope of the SRM mirrors that of the SSM, that is, all of the banks in the Eurozone and other member states. Its functioning is detailed as follows: at the core lies the Single Resolution Board (SRB) which manages the SBRF, constituted from direct contributions from Eurozone banks. The ECB, as well as national supervisory bodies when applicable, has the task of supervising the banks in the Eurozone and making the necessary notifications to the SRB. When required, the SRB instructs the national resolution authorities to resolve a failed bank by bailing-in, or allocating losses primarily on shareholders and creditors. Once this point has been surpassed, the SRB can access the SBRF upon approval of the Commission.

The procedure of triggering the resolution mechanism is as follows: a) the SRB (generally based on information from the ECB but not constrained by it) determines if a bank is failing or likely to do so, b) it assesses if such a failure poses (i) a threat to public interest and (ii) there is no alternative solution that does not require public involvement, c) the Board then adopts a resolution scheme with the appropriate measures.

In a press statement on April 15th, 2014, Internal Market and Services Commissioner Michel Barnier announced the completion of the Banking Union proposed by the Commission in its 2012 five pillar outline. Barnier highlighted the successful completion of the Banking Union in a period of less than two years and without any additional burdens on the taxpayers.[94] The SRM, the BRRD and the reform of the 1994 Directive on Deposit Guarantee Schemes (DGS) complement the SSM to address the main concerns that drove the original proposal.

The only element that was left out was a Common Fiscal backstop to fund these projects, instead opting for the creation of resolution and deposit guarantee funds from levies on the banking sector. The main political goal of the Banking Union was achieved: an agreement to

[94] (European Commission 2014)

CEU eTD Collection

curtail financial fragmentation in the Eurozone without entering into fiscal reform and without placing additional burden on taxpayers. The crisis demonstrated the costs of bail-outs and that lesson was internalized by the institutions of the European Union. However, the question that remains is: are these measures enough to reduce the market distortions caused by political fragmentation in the currency union?

Discussion

The 2012 report issued by the Presidents of the Commission, the Council, the Euro group and the ECB title "Genuine Economic and Monetary Union". The document stressed the importance of coherence in the domestic economic policies for the survival of the currency union. Policy coordination is seen as the solution to the problems posed by political fragmentation. Thus, economic policy and budgetary frameworks were proposed in addition to the common financial framework that inspired the Banking Union. However, the report also stresses the need for legitimacy and public support in order to advance the integration process.[95] The idea behind this blueprint for future integration is that the Banking Union needs to be complemented by a Fiscal, and ultimately political, Union.

The debate over the need for a shock absorbing mechanism for the Eurozone is not new, nor is the idea that there is a need to complement the currency union with a large federal budget. By taking the United States as a comparison, Gross[96] argues that a large federal budget is not necessary to absorb shocks, but rather serves more effectively as a regional redistribution mechanism. The Banking Union is an effective shock absorption mechanism insofar as it

[95] (European Commission 2012)
[96] (Gros 2013, 67)

CEU eTD Collection

includes not only a common crisis management framework, but also a fund with which to resolve failed institutions and reduces the incentives for speculative waves against the Euro or a generalized bank-run scenario fueled by fears of redenomination. A regional redistribution mechanism has, on the other hand, proven to be politically toxic, as was exemplified by the rise of the far right and of euro-skepticism in recent years. Considering the public demand for fiscal neutrality and the important regional asymmetries in income, savings and consumption patterns[97], a larger budget is politically unviable and the only acceptable compromise for a common fund was that it would be levied on the banking sector.

Though the SRM and SSM serve to ameliorate the effects of asymmetric shocks by reducing risks of contagion or of political intervention, they do not attack the source of the problem. A fundamental issue is that of macroeconomic policy coordination. While the agreed-upon mechanisms do tackle the sources of political fragmentation, understood as the arbitrary use of regulatory powers by national governments, the main cause of market distortion is not addressed. Differences in crisis management strategies by national governments served the functions of catalyzers of market distortions; however, the fundamental cause of the change in market trends was that market actors came to the realization that different macroeconomic policies conveyed distinct risks of default.

There is temptation among policy makers to scape-goat the crisis and bank managers for chronic macroeconomic mismanagement. Though it was clear from the onset that the credit boom would devolve into unsustainable economic policies, the extent of the collapse was unknown and the political costs associated with privileging economic rationalities impeded corrective

[97] (Howarth and Quaglia 2013)

CEU eTD Collection

measures. Csaba[98] argues that the time distance between policy action and actual outcome as well as the democratic cycles make long-term planning difficult, making successors harvest the success of long term policies (traditionally unpopular). This helps explain the emergence of the unsustainable imbalances in the Eurozone that were at the core of the collapse.[99]

For example, the wage-growth policies adopted in Germany have effects throughout the Eurozone as they determine the amount of savings in Euros; the tight macroeconomic policies pursued by the German government translate into excess savings that flood the financial markets of other, less developed, members of the currency union. While there are exchange rate or commercial adjustment mechanisms that would correct these distortions without the economic arrangements of the EU, the policy tools available to the countries that are at the receiving side of this boom are limited. This, coupled with the fact that there are very few political incentives to cool down the economy during the good times, resulted in the creation of great internal imbalances within the currency union. Though the scope and severity of these imbalances is a hotly debated issue[100] the reality is that the financial framework included in the Banking Union, or its proposal for that matter, does not address these concerns.

Considering the current unpopularity of the EU, and thus the public reluctance to further integration, the question that remains is: was the crisis wasted? Major crises open the door for major reforms[101], however; the Banking Union can hardly be considered a major overhaul of the European financial system. Its deficiencies have been widely explored. The fact that the Eurozone lacks a commonly issued debt means that Banks will still be largely exposed to the debt

CEU eTD Collection

[98] (Csaba 2011)
[99] (Sinn and Valentinyi 2013)
[100] (Eichengreen 2011, Pettis 2013, Sinn and Valentinyi 2013)
[101] (Gourevitch 1986)

issued by their national government; the SSM only puts some distance between but does not address the core issue.[102] Likewise, though the SRM does give solidity to the banking sector, the fact that sovereigns are still considered risk free debt according to EU capital requirements and that national governments still hold the prerogative to pre-empt the SRM and come to the rescue of their banking sector translates into a still fragmented sovereign debt market[103]. The Banking Union is a good coordination mechanism and increases transparency in the financial governance process, however; it does little to correct the underlying political fragmentation that led to the crisis in the first place. All of this would suggest that the crisis has been in fact a wasted opportunity.

From a purely economic standpoint, the real utility of the Banking Union is at best questionable. However, this ignores the political side of the story. The political costs of pushing through the reforms that the currency union requires would have been unbearable. The demand for fiscal neutrality and the regional antagonisms, fueled by a short-sighted view, clash with the long-term needs of the Eurozone. The Banking Union can only be described as the minimum acceptable measure that was politically viable at the time.

Rather than a *panacea*, the Banking Union is a crisis management tool, a tool that was designed upon the notion that increasing economic integration in the European Union is the correct strategy. It is a step in that direction, but it does not address some of the key underlying problems that the European financial system as a whole faces.

CEU eTD Collection

[102] (Whyte 2012)
[103] (Valiante 2014)

Conclusions

The theoretical contributions on international financial governance and integration are still limited. This thesis contributes to the literature by exploring the conditions under which successful regulatory convergence outcomes can occur. I argue that the genesis of Banking Union was possible due to the fact the both the supply side (institutions) and demand side (the post-crisis political upheaval) criteria were fulfilled. In turn, its design reflects the calculation between the need for stability and the social demands for fiscal neutrality and transparency and the preferences to retain sovereignty over crisis management policies.

The literature on political risk indicates that credible threats of the arbitrary use of regulatory and taxation prerogatives have negative effects on financial stability. This effect is enhanced by the existence of redenomination risks that stem from the real or perceived unsustainability of the macroeconomic policies of member states. The evidence presented in this thesis indicates that there was an evident increase in financial fragmentation in the Eurozone sovereign debt markets after the 2008-2009 crisis. It is argued that this change in market behavior can be attributed to surfaced concerns over country-specific risks.

Aside from the regulatory dimension of political risk considered in this thesis, the lack of economic policy coordination is the ultimate cause for the challenges that stem from political fragmentation in the currency union. This goes well beyond fiscal discipline, it has to do with the core development models that each member state adopts. These changes were, however, politically impossible to implement, making the BU the only viable step forward in the integration process. Thus, the Banking Union is a crisis management tool designed to address the

CEU eTD Collection

financial fragmentation within the Eurozone that is, in turn, a function of the political fragmentation of the Eurozone.

The ensuing question is: is the Banking Union enough? And, if so, what can be done to ensure its effectiveness? Regarding the first question, though it does not go as far as to completely eradicate the existing redenomination risks by proposing a credible fiscal coordination system –thus discarding the risk of counterbalancing or even contradicting macroeconomic policies within the monetary union–, it does reduce the threat of arbitrary use of regulatory prerogatives by enacting common resolution policies and breaking the vicious supervisory cycle that ties sovereign debt consumers with their regulators. In this sense, it is the minimum common denominator that could pass the test of the politically viable.

As for the second question, the effectiveness of the Banking Union derives from the reduction of country-specific risks. In order to fulfill its objective, changes to the capital requirements frameworks and the development of mutualized financial instruments (Eurobonds) might be necessary. In conclusion, if considered as a remedy, the Banking Union falls short of its goal to "Complete and Strengthen the Monetary Union"; if it is considered as a first step in a long process, then the scenario is more promising. The final outcome will largely depend on the sustained momentum of the demand for reform, or the emergence of another, deeper crisis.

CEU eTD Collection

References

Alesina, Alberto, Vittorio Grilli, and Maria Milesi. "The Political Economy of Capital Controls." *NBER Working Paper*, no. 4353 (1993): http://www.nber.org/papers/w4353.

Allen, Franklin, Elena Carletti, and Joanna Gray. *Political, Fiscal and Banking Union in the Eurozone.* Philadephia: FIC Press, 2013.

Broz, Lawrence, and Jeffry A. Frieden. "The Political Economy of International Monetary Relations." *Annual Review of Political Science* 4 (June 2001): 317-343.

Chul, Yung, and Charles Wyplosz. *Monetary and Financial Integration in East Asia: The Relevance of European Experience.* United Kingdom: Oxford University Press, 2010.

Claessens, Stijn, y Luc Laeven. «What drives banking competition? Some international evidence.» *Journal of Money Credit and Banking* 36, nº 4 (2004): 711-734.

Cohen, Benjamin. *The international political economy of monetary relations* . Hants: Aldershot, 1993.

Collier, David. «Understanding Process Tracing.» *PS: Political Science and Studies* 44, nº 4 (2011): 823-830.

Council of the European Union. «Council agrees general approach on Single Resolution Mechanism.» *Press Releases Database.* 18 de December de 2013. http://ec.europa.eu/internal_market/finances/banking-union/ (último acceso: 18 de December de 2013).

Csaba, Lászlo. "And the first shall be the last." *Hungarian Studies* 25, no. 2 (2011): 235-248.

CEU eTD Collection

Eichengreen, Barry. *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System.* United States: Oxford University Press, 2011.

Elliot, Douglas J. "Key issues on European Banking Union: trade-offs and some recommendations." *Global Economy and Development at Brookings* Working Paper, no. 52 (2012): 64.

European Central Bank. *Euro area yield curve.* 05 23, 2014. http://www.ecb.europa.eu/stats/money/yc/html/index.en.html (accessed 05 24, 2014).

—. *General Description of ECB yield cruve methodology.* 05 2014. http://www.ecb.europa.eu/stats/money/yc/html/technical_notes.pdf (accessed 04 26, 2014).

—. *Long-term interest rate statistics for EU Member States.* 04 10, 2014. http://www.ecb.europa.eu/stats/money/long/html/index.en.html (accessed 04 10, 2014).

European Comission. "Legislative package for banking supervision in the Eurozone – frequently asked questions." *Press release databases.* 09 12, 2013. http://europa.eu/rapid/press-release_MEMO-13-780_en.htm?locale=en (accessed 04 25, 2014).

European Commission. «Commission proposes new ECB powers for banking supervision as part of a banking union.» *Press Releases Database.* 12 de September de 2012. http://europa.eu/rapid/press-release_MEMO-12-662_en.htm?locale=en (último acceso: 2013 de December de 13).

—. "Finalising the Banking Union: European Parliament backs Commission's proposals (Single Resolution Mechanism, Bank Recovery and Resolution Directive, and Deposit Guarantee

CEU eTD Collection

Schemes Directive)." *Press releases database.* 04 15, 2014. http://europa.eu/rapid/press-release_STATEMENT-14-119_en.htm?locale=en (accessed 05 2014, 13).

—. «MEMO/12/662.» *Press Releases Database.* 2012 de September de 2012. http://europa.eu/rapid/press-release_MEMO-12-662_en.htm?locale=en (último acceso: 12 de December de 2013).

—. «MEMO/13/780.» *Press Releases Database.* 12 de September de 2013. http://europa.eu/rapid/press-release_MEMO-13-780_en.htm?locale=en (último acceso: 11 de December de 2013).

—. «The SRM – essential for a stronger single market & EMU and to avoid bank bail-outs.» *Press Releases Database.* 12 de September de 2013. http://ec.europa.eu/internal_market/finances/banking-union/ (último acceso: 18 de December de 2013).

—. "TOWARDS A GENUINE ECONOMIC AND MONETARY UNION." *Press Release Databases.* 06 26, 2012. http://ec.europa.eu/economy_finance/crisis/documents/131201_en.pdf (accessed 05 29, 2014).

Frankel, Jeffrey A. *No Single Currency Regime is Right for All Countries or At All Times.* Washington D.C.: NBER Working Paper, 1998, http://www.nber.org/papers/w7338.

Frieden, Jeffry A. "Invested interests: the politics of national economic policies in a world of global finance." *International Organization* 45, no. 4 (1991): 425-451.

CEU eTD Collection

Frieden, Jeffry A. «Invested interests: the politics of national economic policies in a world of global finance.» *International Organization* 45, nº 4 (1991): 425-451.

Frieden, Jeffry, and Lisa Martin. "International Political Economy: The State of the Sub–Discipline." In *Political Science: The State of the Discipline, Centennial Edition*, by Helen Milner, & Ira Katznelson, 1040. United States: W. W. Norton & Company, 2003.

Frieden, Jeffry, and Lisa Martin. "International Political Economy: The State of the Sub–Discipline." In *Political Science: The State of the Discipline, Centennial Edition*, by Helen Milner, & Ira Katznelson, 1040. United States: W. W. Norton & Company, 2003.

Gandrud, Christopher. "The diffusion of financial supervisory governance ideas." *Review of International Political Economy* 20, no. 4 (2013): 881–916.

Garman, David M. "Policy Rules, Inflationary Bias, and Cyclical Stability." *Journal of Money, Credit and Banking* 21, no. 4 (1989): 409-421.

Germain, Randall. "Governing global finance and banking." *Review of International Political Economy* 19, no. 4 (October 2012): 530-535.

Goldstein, Morris, and Nicolas Véron. *Too Big to Fail: The Transatlantic Debate.* Peterson Institute for International Economics, Washington D.C.: Working Paper Series, 2011, 41.

Goodman, John B., and Louis W. Pauly. "The Obsolescence of Capital Controls?: Economic Management in an Age of Global Markets." *World Politics* 46, no. 1 (1993): 50-82.

Gourevitch, Peter A. *Politics in Hard Times. Comparative Responses to International Economic Crises.* United States: Cornell University Press, 1986.

CEU eTD Collection

Gourevitch, Peter A. "Yet more hard times? Reflections on the Great Recession in the Frame of Earlier Hard Times." In *Politics in the New Hard Times. The Great Recession in Comparative Perspective*, by David A. Lake, & Miles Kahler, 252-274. United States: Cornell University Press, 2013.

Gros, Daniel. "Banking Union instead of Fiscal Union?" In *Political, Fiscal and Banking Union in the Eurozone?*, by Franklin Allen, Elena Carletti, & Joanna Gray, 65-79. Philadephia: Wharton Financial Institutions Center, 2013.

Helleiner, Eric, and Tony Porter. "Making Transnational Networks More Accountable." In *Re-Defining the Global Economy*, by Friedrich-Ebert-Stiftung, 14–24. NewYork: Friedrich Ebert Stiftung Occasional Paper No. 42, 2009.

Howarth, David, and Lucia Quaglia. "Banking Union as Holy Grail: Rebuilding the Single Market in Financial Services, Stabilizing Europe's Banks and 'Completing' Economic and Monetary Union." *Journal of Common Market Studies* 51, no. Annual Review (2013): 103-123.

Kudrna, Zdenek, and Daniela Gabor. "The Return of Political Risk: Foreign-Owned Banks in Emerging Europe." *Europe-Asia Studies* 65, no. 3 (May 2013): 548–566.

Lall, Ranjit. "From failure to failure: The politics of international banking regulation." *Review of International Political Economy* 4, no. 19 (2012): 609-638.

Major, Aaron. "Neoliberalism and the new international financial architecture." *Review of International Political Economy* 4, no. 19 (2012): 536–561.

CEU eTD Collection

Mattli, Walter. "Explaining Regional Integration Outcomes." *Journal of European Public Policy* 6, no. 1 (1999): Journal of European Public Policy.

Mattli, Walter, and Ngaire Woods. *The Politics of Global Regulation.* Princeton: Princeton University Press, 2009.

Mattli, Walter, and Ngaire Woods. "The Politics of Global Regulation." In *In whose benefit? Explaining regulatory change in global politics*, by Walter Mattli, & Ngaire Woods, 312. Princeton: Princeton University Press, 2009.

Mosley, Layna, and David Andrew Singer. "The Global Financial Crisis: Lessons and Opportunities for International Political Economy." *International Interactions* 35, no. 4 (2009): 420-429.

Odell, John S. «Case Study Methods in International Political Economy.» *International Studies Perspectives* II (2001): 161-176.

Pettis, Micheal. *The Great Rebalancing: Trade, Conflict, and the Perilous Road Ahead for the World Economy.* Princeton: Princeton University Press, 2013.

Putnam, Robert D. "Diplomacy and Domestic Politics: The Logic of Two-Level Games." *International Organization* 43, no. 3 (1988): 427-460.

Rey, Hélène. "Fiscal Union in the Eurozone?" In *Political, Fiscal and Banking Union in the Eurozone?*, by Franklin Allen, Elena Carletti, & Joanna Gray, 107-116. Philadephia: Wharton Financial Institutions Center, 2013.

Ruggie, John. "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order." *International Organization* 36, no. 2 (1982): 379-415.

CEU eTD Collection

Simmons, Beth A., and Zachary Elkins. "The Globalization of Liberalization: Policy Diffusion in the International Political Economy." *American Political Science Review* 98, no. 1 (February 2004): 171-189.

Singer, David Andrew. "Capital Rules: The Domestic Politics of International Regulatory Harmonization." *International Organization* 58, no. 3 (July 2004): 531-565.

Singer, David Andrew. "Capital Rules: The Domestic Politics of International Regulatory Harmonization." *International Organization* 58, no. 3 (July 2004): 531-565.

Sinn, Hans-Werner, and Akos Valentinyi. *European imbalances- VOX*. 04 09, 2013. http://www.voxeu.org/article/european-imbalances (accessed 05 30, 2014).

Solingen, Etel. "The Genesis, Design and Effects of Regional Institutions: Lessons from East Asia and the Middle East." *International Studies Quarterly* 52, no. 2 (2008): 261-294.

Turner, Phillip. "Benign Neglect of the Long-Term Interest Rate." *BIS Working Papers*, no. 403 (2013): 45.

Valiante, Diego. "Framing Banking Union in the Euro Area: Some empirical evidence." *CEPS Working Document*, no. 389 (February 2014): 26.

Véron, Nicolas. "A Realistic Bridge Towards European Banking Union." *Bruegel Policy Contribution*, no. 09 (June 2013): 17.

Vogel, David, and Robert A. Kagan. "National Regulations in a Global Economy." In *Dynamics of Regulatory Change: How Globalization Affects National Regulatory Policies*, by Kagan Vogel, & Robert A. Kagan, 385. California: UC Press, 2002.

CEU eTD Collection

Waller, Christopher J. «Monetary Policy Games and Central Bank Politics.» *of Money, Credit and Banking* 21, nº 4 (1989): 422-431.

Whyte, Philip. *What a Banking Union Means for Europe.* London: Center for European Reform, 2012.

Wood, Duncan. *Governing Global Banking: The Basel Committe and the Politics of Financial Globalisation.* Hants: Ashgate, 2005.

Wyplosz, Charles. «How Risky is Financial Liberalization in the Developing Countries?» *Comparative Economic Studies*, 2002.

Young, Kevin L. "Transnational regulatory capture? An empirical examination of the transnational lobbying of the Basel Committee on Banking Supervision." *Review of International Political Economy* 4, no. 19 (2012): 663–688.

CEU eTD Collection