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Banking in Europe: Disentangling a Twin Crisis

The on-going sovereign debt crisis in Europe continues to put strains on banks' balance sheets but also the Single European Market in banking. Rather than disentangling the sovereign debt and bank crises, recent policy decisions have tied the two even closer together. The use of the additional liquidity provided by the ECB through longer-term refinancing operations (LTRO) by some banks to stock up on government bonds has tied the fate of sovereigns and banks even closer together. And while first steps have been taken to address (i) sovereign insolvency of some periphery countries and (ii) the risk of sovereign illiquidity turning into a self-fulfilling solvency crisis in some other countries, there are still no proper mechanisms in place to address either. This paper discusses the critical role of the European banking system and its regulation in this crisis. I argue that without disentangling bank and sovereign debt fragility, the euro area will not get out of the current crisis. Similarly, the euro area can only become a sustainable currency union if the regulatory dichotomy between macro and financial stability is overcome and an effective European financial safety net is created.

The current euro area crisis is a child of the 2007/8 Global Financial Crisis and the failure of European policy makers to respond to the crisis by building the appropriate frameworks and institutions. It has made obvious the trilemma of the European Banking Market, i.e. the impossibility to maintain financial stability with cross-border banking and national regulation. It has also shown that the home bias in government security holdings ties banks and sovereign closer together and can result in negative feedback loops. In summary, not having addressed the underlying weaknesses of banks and the institutional frameworks to deal with bank and sovereign fragility has exacerbated the crisis and made a rapid exit all but impossible. In turn, it points to reforms in bank regulation and resolution frameworks as a critical entry point to solve the current crisis.

This paper first discusses the trends towards cross-border banking in the early 21st century and how they interacted with other trends in the financial system to form the financial system as we observed it in 2007 before the outbreak of the Global Financial Crisis and what benefits and risks this has brought for Europe and the euro area. I then turn to the implications of cross-border banking for the stability framework and

argue that monetary and financial stability can no longer be targeted separately, but have to be approached in a joint framework. Finally, I address the short-term needs during the current crisis, which involve cutting the unhealthy link between sovereign and banks, especially in periphery countries, to help address the fragility on both sides.

Before moving on, let me note that a large part of the analysis in this paper is based on a CEPR policy report that I co-authored with *Franklin Allen, Elena Carletti, Philip Lane, Dirk Schoenmaker* and *Wolf Wagner*. While we finalized

this report in April 2011, the orderly default by Greece and the continuous doubts on debt sustainability of Ireland and Portugal and, more recently, Spain, and concerns on some other peripheral states have reinforced the messages in this report. The on-going crisis has also reinforced regulatory instincts to focus on national interests and stakeholders when it comes to cross-border banking, which makes exit from the crisis even more difficult.

How Did We Get Here?

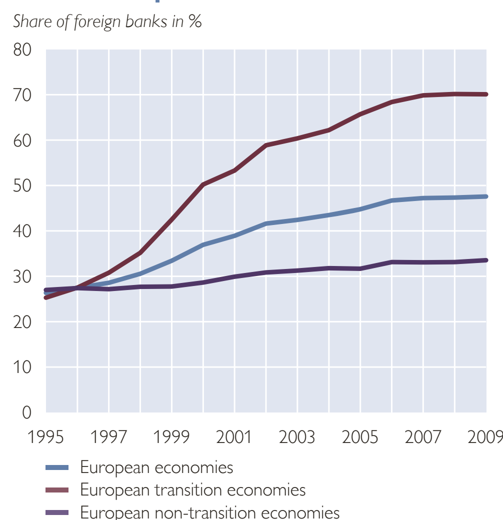
The monetary union was supposed to be the crowning element for a single economic area in Europe, eliminating exchange rate uncertainty and thus further boosting economic exchange across borders and free flows of capital and labor. At the same time, a regulatory framework for cross-border banking within Europe was established, in the form of several European Banking Directives, with the objective of creating a single market in banking. The introduction of the euro in 1999 eliminated currency risk and provided a further push for financial integration (Kalemli-Ozcan, Papaioannou, and Peydró, 2010). Chart 1 illustrates this trend towards increasing importance of cross-border banks across European financial systems. This trend towards cross-border banking can also be seen in an increasing share of cross-border merger and acquisitions in total merger and acquisitions, as documented by Buch and DeLong (2010). Finally, this trend towards cross-border banking can also be illustrated for individual banks in Europe. The percentage of foreign assets in total assets is 82% for Deutsche Bank, 64% for Santander, 62% for UniCredit, 41% for BNP Paribas and 29% for Societe Generale (Allen et al., 2011). And the trends towards globalization went hand in hand with a trend towards consolidation, with the result that the largest banking groups controlled more than 16% of global banking assets in 2008, more than double their market share in 1998 (Claessens et al., 2010). Globalization and consolidation were accompanied by several other important trends in the financial system, including a trend towards less safe assets on banks' balance sheets, partly driven by the low interest rate environment and consequent search for yield, and a move away from high-cost but stable retail funding towards lower-cost but more volatile wholesale funding. All of these trends were the backdrop on which the subprime mortgage crisis in the USA hit the global financial system in 2007.

When the 2007 crisis erupted in the U.S., cross-border banks were an important transmission channel. In a financially integrated world, where large shares of assets are traded on international markets and with high amounts of inter-bank claims across borders, the contagion effects were pronounced and immediate, going

Chart 1

Cross-Border Banking in the European Union

Share of foreign banks in %



Source: Author's calculations based on Claessens and van Horen (2011).

through direct cross-border lending, local lending by subsidiaries of large multinational banks and lower access of local banks to international financing sources.

The Global Financial Crisis of 2007/8 saw a striking asymmetry between the reactions by monetary and by regulatory authorities. The shock that the Lehman Brothers failure in September 2008 caused on global financial markets is illustrative for this. While central banks coordinated well to address the liquidity crisis in the international financial markets, regulators did not coordinate well when it came to dealing with failing cross-boarder financial institutions, as became obvious in the cases of the Benelux bank Fortis and the Icelandic banks. In the case of Fortis, in spite of MoUs and close cooperation of supervisors, resolution of the bank had to be nationalized, i.e. the bank had to be split up along national borders, and ultimately the three pieces had to be nationalized. In the case of the Icelandic banks, default led to an uneven treatment of national and international creditors and a political crisis within Iceland and between Iceland and several other European countries. Over time, coordination improved, as most obvious from the Vienna initiative, where coordination between international financial institutions, regulators and banks led to several cross-border banks making specific rollover and recapitalization commitments vis-à-vis their subsidiaries in Central and Eastern Europe (De Haas et al., 2012). However, as I discuss below, these attempts at coordination are still mostly ad-hoc rather than based on a robust institutional framework.

The Benefits and Risks of Cross-Border Banking

The benefits and risks of cross-border banking have been extensively analyzed and discussed by researchers and policy makers alike. Cross-border banking can bring competition and higher efficiency into host countries, thus helping to deepen and broaden financial sys-

tems as seen most prominently in Central and Eastern Europe during the late 1990s and early 2000s. The main stability benefits stem from diversification gains; in spite of the Spanish housing crisis, Spain's large banks remain relatively solid, given the profitability of their Latin American subsidiaries. Similarly, foreign banks can help reduce funding risks for domestic firms if domestic banks run into problems. However, there are also significant costs of cross-border banking, though they do not necessarily materialize at the same time as the benefits. Foreign capital is likely to be more mobile than domestic capital and in a crisis situation, foreign banks may simply decide to "cut and run". As seen in Central and Eastern Europe, there is a regulatory and political bias to force large cross-border banks to withdraw from host economies and focus on home markets. There is also the risk of contagion: in the same way as cross-border banking insulates

the domestic economy from domestic shocks, it also exposes it to foreign shocks (Degryse, Elahi and Penas, 2010) As became obvious in the recent crisis, the formation of cross-border banks has also increased the complexity, the interconnectedness and the size of institutions and their failure may thus impose significantly higher costs on economies than the failure of a purely domestic bank.

The costs of cross-border banking might outweigh the diversification benefits if outward or inward bank investment is too concentrated. Several Central and Eastern European countries are highly dependent on a few West European banks, and the Nordic and Baltic region are relatively interwoven without much diversification.

At the system-level, the EU is poorly diversified and is overexposed to the United States, which explains why it was harder hit by the Global Financial Crisis than other regions of the world (Schoenmaker and Wagner, 2011). While regulatory interventions into the structure of cross-border banking would be difficult if not counter-productive, a careful monitoring of these imbalances is called for.

Beyond the geographic diversification of bank flows, there is an obvious need to focus on specific financial institutions. The crisis of 2008 has clearly shown the deficiencies of both national, but especially of cross-border bank resolution frameworks. Most European countries did not have the necessary tools to deal with failing banks beyond forcing them into regular liquidation processes – with all the negative contagion and spill-over risks this has for the rest of the financial system and the negative repercussions for the economy at large – or bailing them out with taxpayers having to bear the consequences of private risk decisions and thus creating moral hazard risk. While these external costs of bank failure call for specific bank resolution frameworks on the national level to minimize the external costs of bank failure and moral hazard risks at the same time, there are additional frictions and externalities that call for a special focus of regulators on cross-border banks. First, cross-border banking increases the similarities of banks in different countries and raises their interconnectedness, which, in turn, can increase the risk of systemic failures even though individual bank failures become less likely due to diversification benefits (e.g., Wagner, 2010). Second, national supervision of cross-border banks give rise to distortions as shown by Beck, Todorov and Wagner (2012). The home-country regulator will be more reluctant to intervene in a cross-border bank the higher the share of foreign deposits and assets and more likely to intervene the higher the share of foreign equity. The reason for this is that a higher asset and deposit share outside the area of supervisory responsibility externalises part of the failure costs, while a higher share

of foreign equity reduces the incentives to allow the bank to continue, as the benefits are reaped outside the area of supervisory responsibility. This bias became obvious during the 2007/08 crisis, when banks with a higher share of foreign ownership were intervened at an earlier point of fragility, while banks with a higher share of foreign assets and deposits were intervened at a later point (Beck, Todorov and Wagner, 2012).

In the wake of the crisis, attempts have been made to address these gaps in resolution frameworks, both on the national but also on the European level. Following the de Larosière (2009) report, the European Banking Authority (EBA) was established to more intensively coordinate micro-prudential issues, while the European Systemic Risk Board (ESRB) is in charge of addressing macro-prudential issues. Further reaching reform suggestions, such as creating a European-level supervisor with intervention powers or a European deposit insurance fund with resolution powers modeled after the U.S. FDIC (Federal Deposit Insurance Corporation or the Canadian CDIC (Canada Deposit Insurance Corporation), however, were rejected, mostly based on arguments of the principle of subsidiarity, national sovereignty over taxpayers' money that might be needed for resolution of large cross-border banks and the need to amend European treaties.

Given the biased incentives of national regulators discussed above, however, there is a strong case for a Pan-European regulator with the necessary supervisory powers and resources. While different institutional solutions are possible, a European-level framework for deposit insurance and bank resolution is critical in order to enable swift and effective intervention into failing cross-border banks, reduce uncertainty and strengthen market discipline. Depending on the choice of resolution authority (supervisor or central bank), the new European Banking Authority (EBA) or the European Central Bank (ECB) can be given this central power in the college of resolution authorities. In addition, resolution and recovery plans, also known as living wills, for cross-border banks should be developed to allow for an orderly winding down of (parts of) a large systemic financial institution. As large financial institutions have multiple legal entities, interconnected through intercompany loans, it is most cost effective to resolve a failing bank at the group level. This can imply a split-up of the group, sale of parts to other financial institutions and liquidation of other parts. In this context, *ex ante* burden-sharing arrangements should be agreed upon to overcome coordination failure between governments in the moment of failure and ineffective *ad hoc* solutions. By agreeing *ex ante* on a burden-sharing key, authorities are faced only with the decision to intervene or not. In that way, authorities can reach the first-best solution in a swift way. It also helps overcome the time inconsistency problem of bank resolution, where the optimal solutions ex-ante and ex-post vary, which creates moral hazard risks. While burden-sharing should be applied at the global level, it can only be enforced with a proper legal basis. That can be provided at the EU level, or at the regional level. A first example, albeit legally non-binding, is the Nordic Baltic scheme.

Critically, such a cross-border supervisory and resolution authority needs the necessary resources to resolve large cross-border banks in an efficient manner. That is why a combination of the resolution authority with a deposit insurance scheme for cross-border banks might be necessary. In-

dustry-based funding for such a scheme is also called for to reduce concerns of moral hazard, where the downside risk of banks' risk-taking is borne by taxpayers. Since deposit insurance, even if financed by banks themselves, always faces limitations in case of systemic bank failure, however, a back-stop by national governments, possibly through a European institution, such as the EFSF, is necessary.

Linking Financial and Macro-Stability

The euro area crisis is as much a joint sovereign debt and banking crisis as it is a crisis of governance. Large imbalances have built up since the introduction of the euro, driven partly by divergent real exchange rates, non-synchronized business cycles, and capital flows attracted by housing bubbles. As pointed out by many commentators, however, the aggregate fiscal position of the euro zone is stronger than that of the UK, the USA or Japan. Take for example the fiscal deficit, which is predicted to reach 3.4% in 2012 in the euro area, compared to 7.6% in the USa, 7.7% in the UK and 8.0% in Japan. Similarly, the euro area as aggregate runs a current account surplus, unlike the USA and the UK. However, behind this relatively favorable aggregate picture lies a large variation within the euro area and the necessary institutions to address these internal macroeconomic imbalances are missing. While this holds true for many policy areas, most prominently fiscal policy, this has become especially clear in the area of cross-border banking.

The crisis has raised fundamental questions on the interaction of monetary and financial stability. While the inflation-targeting paradigm treated monetary and financial stability as separate goals, with monetary policy aiming at monetary stability and micro-prudential policy aiming at financial stability, the crisis has questioned this approach fundamentally. Inflation targeting was also behind the original Growth and Stability Pact in the Maastricht Treaty and is also the background for the recent Fiscal Compact. This ignores, however, the close interaction between banking and official sector, including through banks holding governments bonds, and the effects of asset and credit bubbles. Both Spain and Ireland fulfilled the Maastricht criteria going into the crisis, but experienced real estate boom and bust cycles, with losses ending up on governments' books, both directly through bank failures as indirectly through recessions driving up deficit and debt to GDP ratios. Similarly, banks' lending retrenchment following the 2007/8 crisis has a negative impact on the private sector and ultimately GDP, which in turn reduces tax revenues, drives up government debt, which ultimately puts banks' balance sheets under pressure, which are full of government bonds. This situation is exacerbated by the home bias in sovereign debt holding, documented by Acharya, Drechsler and Schnabl (2012). In 2010, more than 60% of sovereign bond holdings by Irish, Italian, Portuguese and Spanish banks were domestic government bonds, with this ratio reaching almost 90% in Greece.

The close link between financial and monetary stability requires a new framework for macroeconomic stability, including the use of macro-prudential regulation as additional policy tool beyond micro-prudential regulation. While monetary policy should take into account asset and not only consumer price inflation, one tool is simply not enough to achieve both goals, especially not in a currency union, where asset price cy-

cles are not completely synchronized across countries. Macro-prudential regulation cannot only serve to counter the risk of asset price bubbles, but also mitigate risks stemming from asset concentration and herding behavior. Such regulation would have to be applied on the national, but monitored on the European level. While the experience with such macro-prudential regulation has not been completely satisfactory, as for example in Spain, this does not take away the argument for it, but rater calls for further strengthening.

Another important issue is the close link between sovereign debt and banking crises in the euro area. With banks holding a large share of government bonds (and these bonds constituting a large share of banks' assets), a sovereign debt restructuring as just happened in Greece leaves banks undercapitalized if not insolvent. In times of crisis, incentives to hold government bonds (still considered risk-free thus with no capital charges) increase as the risk profile of real sector claims increases (a trend exacerbated by Basel II, as pointed out by many observers, e.g. Repullo and Suarez, 2012). The government debt overhang in many industrialized countries also creates a political bias towards financial repression to reduce the costs of government debt, with further pressure for financial institutions to hold domestic government debt (Kirkegaard and Reinhart, 2012). This close interaction between banks and sovereigns also influences policy stances, such as that of the ECB until late last year when it opposed even any talk about Greek sovereign debt restructuring as this would prevent it from accepting Greek sovereign debt as collateral for banks, even at the time when it was obvious for all observers that debt restructuring would be all but inevitable.

Several adjustments are therefore needed in the area of sovereign debt, as outlined in more detail in Allen et al. (2011). First of all, government debt should not, per se, be considered risk-free, but incur capital charges according to its risk profile. Second and as consequence of the first, asset concentration ratios should take into account the home bias in government bond holdings and impose diversification requirements. Third, a formal insolvency procedure for sovereign debt is needed within the European Union,

which would limit not only the need for bailouts but also reduce uncertainty and moral hazard risks. One way that such a mechanism could work is for the country to declare it cannot fully meet its debt obligations, to be verified by a team from the IMF, ECB and the European Commission, which would then assist in designing the optimal repayment plan. In addition to such an insolvency procedure and orthogonal to the current debate on Eurobonds, a closer coordination of fiscal policy is necessary, not just to avoid individual countries endangering the currency union with unsustainable fiscal policies, but to avoid procyclicality of fiscal policy as currently to be observed.

Long-Term Reforms, But Short-Term Needs

While the institutional reforms outlined above are necessary for the long-term sustainability of the euro area and a Single European Market in Banking, the euro area is facing immediate needs in fighting the ongoing crisis. There is still a significant capital shortfall in many European banks, not yet fully recognized. The leverage of European banks is almost twice that of U.S. banks; as reported by Feyen, Kibuuka and Ötker-Robe (2012), the asset-equity ratio is 18 to 20 in European banks compared to 10 in the USA. While more recent official stress tests have finally started including sovereign defaults into their scenarios, official calculations, such as the EUR 106 billion announced in October 2012, are intended simply in bringing the necessary capital

to the minimum ratio. Acharya, Schoenmaker and Steffens (2011), on the other hand, calculate a recapitalization need of EUR 200 to 500 billion. The increasing weight of sovereign debt on banks' balance sheets weighs down banks, especially in the periphery. The example of Greece that had to bail out its banks at the same time as it required a bailout for sovereign debt restructuring is illustrative in this context. The close link between banks and sovereign in the periphery countries leads to negative feed-back loops increasing fragility for both, as already discussed above and requires urgent policy action. This close tie also exacerbates the negative impact of fiscal austerity measures on the private sector by increasing the multiplier effect.

While the LTRO started in late 2011 might have succeeded in satisfying immediate liquidity needs of many banks in the euro area, it does not constitute a sustainable solution to the undercapitalization of many banks and might even create new risks. If this additional liquidity is used for private sector lending, this could reduce the impact of fiscal austerity in the periphery countries, while it could also lead to increased risk-taking by banks, given the low interest rates and high leverage of banks (Ongena and Peydro, 2011 and papers cited therein). If on the other hand, banks use the additional cheap liquidity for a carry or "Sarkozy trade"[1] into higher-yield government bonds, this would further strengthen the links between sovereign and bank fragility. The idea that such a carry trade might actually increase profits and ultimately capital buffers of weak bank is a rather high-risk undertaking. In addition, the decentralization of the collateralization process from the ECB down to national central banks, while politically maybe a smart measure, might create a further home bias on banks' balance sheet throughout the euro area. The LTRO is thus at best a second-best, but definitely sub-optimal response by the ECB to both bank and sovereign debt crises. However, rather than tying banks and sovereigns closer together, what is needed is to disentangle the two.

[1] *Named so after the then French president who suggested exactly this bank behavior.*

One possibility to separate sovereign debt and banking crises was suggested by Beck, Uhlig and Wagner (2011) and Brunnermeier et al. (2011). Beck et al. suggest creating a European debt mutual fund, which holds a mixture of the debt of euro area members (for example, in proportion to their GDP). This fund then issues tradable securities whose payoffs are the joint payoffs of the bonds in its portfolio. If one member country defaults or reschedules its debt, this will likewise affect the payoff of these synthetic euro bonds, but in proportion of the overall share in its portfolio. As the share of most periphery countries, including Ireland and Portugal, would be small, a default of one country would not pose a significant risk to the Eurobond. Brunnermeier et al. (2011) suggest a similar structure, though with two tranches of senior and junior debt, with only senior debt being used for banks' refinancing operations with the ECB. The ECB would then use only the new synthetic Eurobonds or European Safe Bonds (ESBies) as collateral in their open market and repurchase operations. This would create a large pool of a new reasonably safe and very liquid asset, that can serve as investment vehicle for global investors and collateral for European banks in their operations with the ECB. It is important to stress that these are not Eurobonds as currently discussed, as they do not imply European mutualization of sovereign debt and are thus also not subject to the criticisms of moral hazard risk and taxation without representation.

Obviously, such a synthetic Eurobond or ESBie would only help separate the two crises, but would not solve either of them. To get these Eurobonds started, European banks would sell their current sovereign debt to the European debt mutual fund and receive synthetic Eurobonds in return, which would make the undercapitalization of many banks transparent as they must realize the losses of peripheral government bonds still held in their books. In the case of banking distress, a proper resolution framework is therefore needed, as discussed above. In the case of sovereign debt crisis, a formal insolvency procedure should be put in place, while at the same time a better firewall is needed to prevent a liquidity crisis in sovereign bonds to turn into a self-fulfilling solvency crisis. Critically, such a construction would benefit the ECB as it no longer faces pressure to purchase bonds from high risk countries and would thus allow a clearer separation of fiscal and monetary policy.

Another immediate concern (which might become more transparent with the above suggestion) is the large undercapitalization of banks, a concern especially in countries with weak fiscal positions, such as Spain. Given the limited resources available for the recapitalization of banks in these countries and in order to turn these banks from being a drag on governments' budgets into growth engines, recapitalization with European resources (such as the EFSF) should be considered. At the same time, the necessary restructuring of banking systems – as currently under way in the Spanish caja market segment – has to be reinforced. Clear recognition of losses and avoidance of any ever-greening of non-performing loans can help avoid a prolonged banking and economic crisis as in Japan in the 1990s. It is important that the current recapitalization of banks in Europe is not be done in the form of balance sheet retrenchment or reallocation, but rather in the form of true additional capital to support the private sector in their way out of the crisis. A growth strategy for the euro area has to focus

on a sound and effective financial system to support private sector growth and counter the effects of the necessary fiscal retrenchment.

Looking beyond Policy to Politics

Beyond the lack of proper policy tools and mechanisms, the euro area faces a deeper crisis, that of a democratic deficit for the necessary reforms to make this monetary union sustainable in the long-run. Political resistance in both core and periphery countries against austerity and bailouts illustrate this democratic deficit, which can also be described as "taxation without representation". In the long-term, the euro area can only survive with the necessary high-level political reforms that return the democratic underpinning to the European project. It is in the context of such a political transformation and integration of the euro area that many of the reforms outlined in this paper will be significantly easier to implement, as for example suggested by Goodhart and Schoenmaker (2011). Some observers have compared the problems of the euro area with the long and painful process that the USA has gone through on its way to an economic union (Aizenman, 2012). Unlike the USA of the 19th and most of the 20th century, however, the euro area has much closer interconnectedness especially in the financial sector. In addition, European political culture of the 21st century is much less willing to allow market forces to determine events.

Outside observers often note a "we are different" approach of European policy makers to the crisis, similarly to the oft-heard "this time is different". There is a lot to be learnt by European authorities from emerging market crises of the past 20 years, including in terms of resolution of systemic banking crises. Yes, European financial systems might be – in the aggregate – in a stronger position than many emerging markets during their respective crises periods. On the other hand, Europe's policy makers are much more constrained in their crisis response, due to the governance challenges and political constraints described above. Unlike in other industrialized countries, there are also constraints on the coordination between monetary and fiscal authorities. The high degree of complacency by euro area policy makers is therefore one of the largest risk factors. Over the past two years, the crisis has been addressed with many ad-hoc solutions, arrived at in the wee hours of emergency summits. None of these "solutions" has addressed the underlying governance challenge or has created even the basis for a sustainable currency union. The risk continues that at some point at some crisis summit, time will be running out and the lack of decision taking will lead to a negative chain reaction and the break-up of the euro area. In the current circumstances (May/June 2012), the largest risk is not that of a Greek exit from the euro area, but rather in how it will be handled by European policy makers.

Conclusions

This paper has been based on the underlying hypothesis that a sound and efficient financial system is critical for the functioning of modern market economies. While the Global Financial Crisis has shown the excesses of financial deepening and the possibility that a financial sector can grow too big for social benefits, it would be dangerous to throw out the baby with the dirty bathwater. Europe needs a strong, stable and efficient financial system that can provide enterprises, households and governments with the necessary financial services. More than ever, this is

necessary to grow out of the current crisis. The Single European Banking Market can bring the necessary competition and scale for the European economy, but it has to be harnessed by an incentive-compatible regulatory framework whose geographic perimeter matches those of the financial institutions it covers. Creating the institutional framework to resolve large cross-border banks with minimal negative externalities for the rest of the European financial system and the real economy should top the reform agenda. An incentive-compatible resolution framework can also influence banks' risk decisions ex-ante and thus reduce fragility.

Don't let a good crisis go wasted! This has been a popular *cri de guerre* following the 2007/08 crisis. Europe, and especially the euro area, did too little after the 2007/08 crisis to address the institutional gaps in the framework that is needed for (i) a stable European banking market and (ii) the interlinkages between monetary and financial stability. It has left policy makers with too few policy tools and coordination mechanisms during the current crisis. Crisis resolution has been mostly reduced to short-term fixes and second-best institutional structures.

The current crisis calls for urgent short-term measures and long-term institution building. Building the necessary institutions to underpin the European Banking Market is obviously only part of a closer economic union and convergence process across many markets and policy dimensions, including labor markets and other factor markets. The critical role of banks as transmission channel of contagion and the close links between banks and sovereign through banks' government bond holding, however, calls for banking reform as priority area. Only by addressing both bank and sovereign bank fragility with European solutions can the two be disentangled and solved.

One can also frame this recommendation in terms of the current political debate on complementing the fiscal with a growth compact. A growth compact focused on increasing the denominator of deficit and debt-GDP ratios is certainly necessary; focusing on the banking system is not only important but also necessary for such a growth compact to have the necessary impact.

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