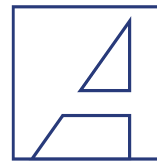

Konrad
Adenauer
Stiftung

INTRODUCTORY PAPER
OF THE GDAŃSK INSTITUTE FOR MARKET ECONOMICS
TO E-DEBATE

CONSEQUENCES OF DEBT CRISIS IN THE EURO AREA FOR EUROPEAN AND POLISH BANKING SECTOR

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The project implemented in cooperation with the Konrad Adenauer Foundation in Poland

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Synthesis

- In late 2009 the global financial crisis entered a new phase, during which the main source of crisis impulses is a market of Treasury securities of euro area countries
- The immediate cause of the crisis is the fear of investors of the insolvency of a number of indebted countries in the euro area. The deeper reason for the crisis is a fundamental loss of investor confidence in the effectiveness of the mechanisms of action of the euro zone - starting with ensuring that member states pursue a responsible economic and fiscal policies, and ending with the ability to resolve the debt crisis
- Loss of investor confidence is a key factor in the process of crisis "contagion", transmitting it to successive countries - this mechanism started a chain reaction that led to the spread of disturbances from one country, Greece, to the so-called peripheral zone countries (Portugal, Ireland), and now threatens major euro zone countries
- Euro zone proved to be totally unprepared for the crisis in public finances - this results from a number of key institutional arrangements of the euro zone, in which a completely centralised monetary policy actually coexists with decentralised fiscal policies of the Member States
- The crisis resolution is significantly complicated by differences of opinion between the main euro area countries, Germany and France, on courses of action and the necessary reforms of the eurozone, and the controversy concerning the role of the European Central Bank in the stabilisation of public finances
- Debt crisis of the euro zone countries is intertwined and mutually reinforcing with the banking crisis in Europe
- Weakness in financial and capital position of European banks is largely a legacy of the banking crisis of the years 2008-09, whose effects have not yet been overcome; threat of losses in connection with the present debt crisis further undermines the investor confidence in banks
- As in the case of a crisis of public finances, dealing with the banking crisis is hampered by the weakness of the euro area institutional mechanisms, in particular the opaque relationship between EU and national banking supervisors and the lack of banking crisis management process
- The potential impact of the financial crisis in the euro area on the Polish banking sector may take place through three channels: macroeconomic effects, foreign funding of Polish banks and the ownership structure of the Polish banking sector.

Introduction

The euro area is currently undergoing a profound public debt crisis, combined with the less spectacular (at least at the moment), but equally serious, structural banking crisis. Both of these crises are interwoven in a kind of feedback, where the weakness of public finances creates negative impulses to the situation of the banking sector, and the unstable financial and capital position of European banks dramatically limits the possibilities and room for maneuver to address the fiscal and economic problems of the eurozone.

This paper presents the characteristics of both the above crises and their interdependence, as well as a brief introduction to the consequences of the current crisis for the Polish banking sector. In principle, the paper does not contain the original author's evaluation and analysis, but is rather an overview of key information and views on the crisis in the euro area, as presented in the recent international economic and financial literature. The purpose of this paper is to initiate discussion on these subjects in the academic and banking world, treated as the first stage of a longer research project conducted by IBnGR.

Title of paper might suggest that the direction of the cause-and-effect relationship leads from the crisis of government debt to the banking crisis, but such an understanding would be a significant over-simplification of the problem. The title expresses only the fact that in the current phase of the global financial crisis, which continues with a varying intensity since 2007 and undergoes a progressive transformation, the main focus of the event has become a government bond market crisis in euro area countries. This market should be treated simply as part of a highly integrated international financial system.

1. Public debt crisis in the euro area

At the turn of October and November 2011, debt crisis in the euro area entered into a critical, qualitatively new phase. The turmoil in the market for government bonds in the euro area spread at this point outside of a group called peripheral countries (Greece, Ireland, Portugal) and claimed Italy - the first of the major countries of the European Union and the euro zone. Evolution of the crisis so far clearly shows how ineffectiveness of the mechanisms of the euro area in addressing the problem of excessive debt of the government of one country, even small, leads to a loss of confidence in financial circles regarding sustainability of public finances across the euro area and causes the effect of "contagion" with the crisis of the next countries of the zone.

Direct mechanism of debt crisis and its transmission to new countries is relatively simple. It can be briefly expressed by the following sequence of events:

- The crisis begins with an event that causes a drop in investor confidence in the ability of the government of a given country to service its debt in a timely manner, and ultimately leads to the sell-off of its Treasury bonds,

- Sustained decline in market prices of bonds causes a successive increase in their yields and hence the need to raise interest rates for new issues,

- If the relevant process is not stopped, the increase in bond yields (the cost of debt) eventually reaches a level that according to the market assessment is not sustainable, i.e. must lead to the insolvency of the country; what follows is an open phase of the crisis – at this moment the government of this country effectively loses access to the market and is forced to ask for international financial assistance.

As one can see, the crisis operates on the principle self-fulfilling prophecy. This psychological mechanism makes that investor confidence, once lost, does not return after the crisis has claimed its first "victim", but conversely, destabilised market after confirmation of its fears is looking for an excuse to attack the next one. The result is the effect of "contagion" with the crisis of successive countries, repeated several times. Of course, the faster it runs, the stronger are the economic and financial links between the group of countries where the crisis began.

The described sequence occurred as yet fully in Greece (May 2010), Ireland (November 2010), Portugal (May 2011) and again in Greece, due to its clear inability to perform according to agreed criteria (additional agreements of July 2011 and October 2011) . Notably, in each of these countries, the crisis reached a critical phase when the bond yield (for the 10-year securities) exceeded the level of 7% points, which in the perception of investors has become something of a solvency indicator. At the same time the market keeps track also of the risk premium that the bonds of a given country show to the "benchmark", i.e. securities with the highest level of security - on the public debt market of the euro area this role is

played by the German bonds, and so far the premium (spread) that determined the moment of entry into the area of acute threat of crisis has amounted to between 4.5 and 5% points.

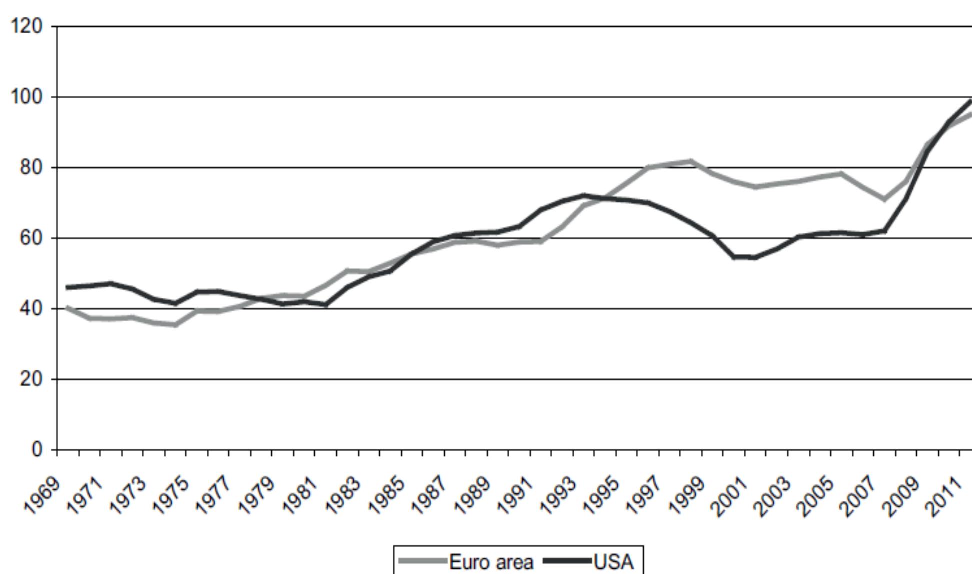
1.1. The genesis of the crisis

The suddenness of the crisis and the ease with which it moves to another country, leads inevitably to the question, what are the reasons for such a great vulnerability of euro area countries to disturbances in the functioning of their public debt markets, especially since it contrasts vividly with the stability of these markets in virtually all previous history of the eurozone.

Data on the fiscal and public debt situation of euro area countries leave no doubt that it is very unfavorable. It is evident, moreover, that the state of public finances has deteriorated significantly in the wake of the 2007-08 financial crisis and that the tendency for an increase in public sector debt in the whole area will continue for some time, despite a number of countries undergoing fiscal consolidation programs. All of these negative circumstances, however, do not explain such a dramatic collapse in investor confidence in the government bond market, which one can currently see.

If one looks at the OECD data on government debt in the euro area over the past four decades, there's a clear long-term trend towards a gradual increase in the debt ratio to GDP, from about 40% in the early 1970s to nearly 90% today. As shown in Figure 1, this ratio more or less stabilised at the time of the creation of euro area at around 80%, even with a slight downward trend, and thereafter only the financial crisis caused a sharp increase in the rate in the period 2007-11.

Figure 1
Public debt of euro area countries and the United States (% of GDP)



Remark: data refer to the first 14 countries of the euro area.
Source: OECD, *Economic Outlook,* as per: Barry Eichengreen i in., *Public Debts: Nuts, Bolts and Worries*. International Center for Monetary and Banking Studies, Geneva Reports on the World Economy 13, September 2011.

It is important to note that the governments of the euro area countries were already highly indebted for a long time before the financial crisis. Data for individual countries show that more than half of them regularly exceed the limit of 60% debt to GDP, which was adopted in the Maastricht Treaty as one of the criteria for fiscal policy discipline required from the Member States. However, this did not cause investors to dump the bonds of those countries.

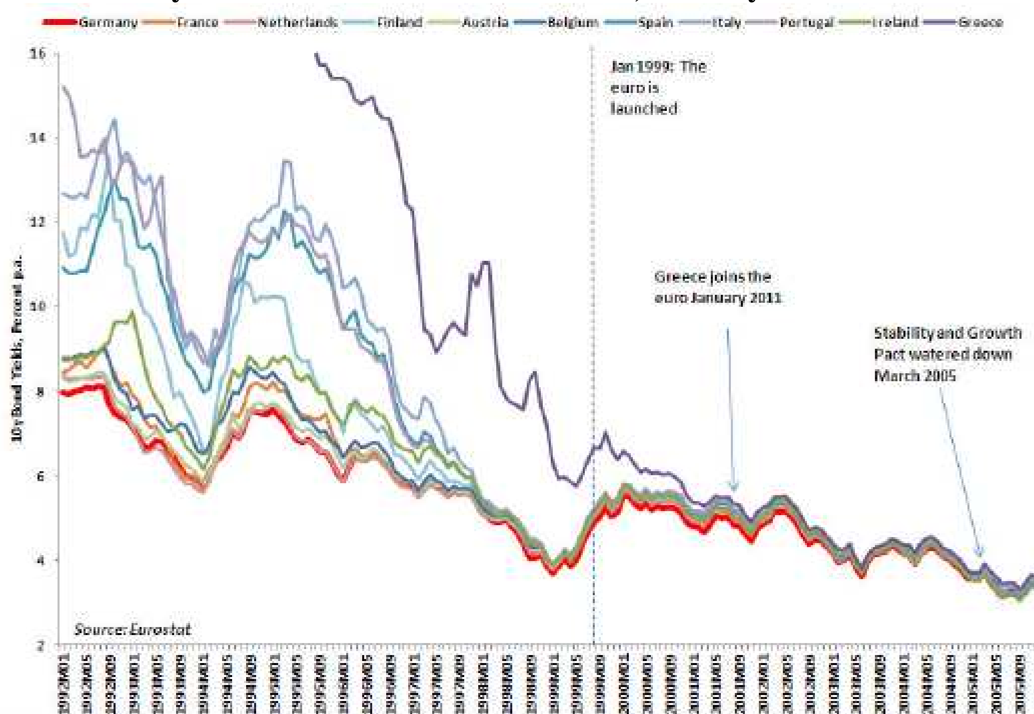
Key information about the public debt market is the level of yields of Treasury securities. The following two graphs show the levels of bond yields in 11 European countries - the first for the years 1992-2005, i.e. the period of progressive integration of the EU countries and preparations for the creation of the euro area as well as the first 7 years of the euro zone existence, and the second for the years 2007-2011, i.e. the period corresponding more or less to the so far duration of the global financial crisis.

Evolution of bond yields on the two graphs is very emblematic. The first shows a progressive compression of yields on bonds of individual countries – as early as in the mid-1990s, the spread of yields amounted to 6% for the group of founding euro zone member countries, and to 10% if you include Greece, but already more than a year before the launch of the euro zone bond yields of the founding countries almost completely leveled. Greek bond yields fell to the level of other countries when Greece joined the euro zone in 2001. This situation meant that investors treat bonds of governments of all countries of the euro area as of the same credit risk, irrespective of significant differences in fiscal and economic situation of individual countries. It is also clear that the factor unifying the risk was the ownership by all countries of the common European currency.

The graph of bond yields in the years 2007-11, in turn, shows the process of rapid decompression of rates for individual countries, testifying to the disintegration of the market and a radical reassessment by investors of their approach to credit risk on the public debt market in the euro area. Despite the common currency, investors began to clearly differentiate the risk of each country. This graph shows, in fact, the essence of the current debt crisis - it is clearly visible how bond yields of the crisis countries - Greece, Ireland and Portugal - increase and become detached from the whole group.

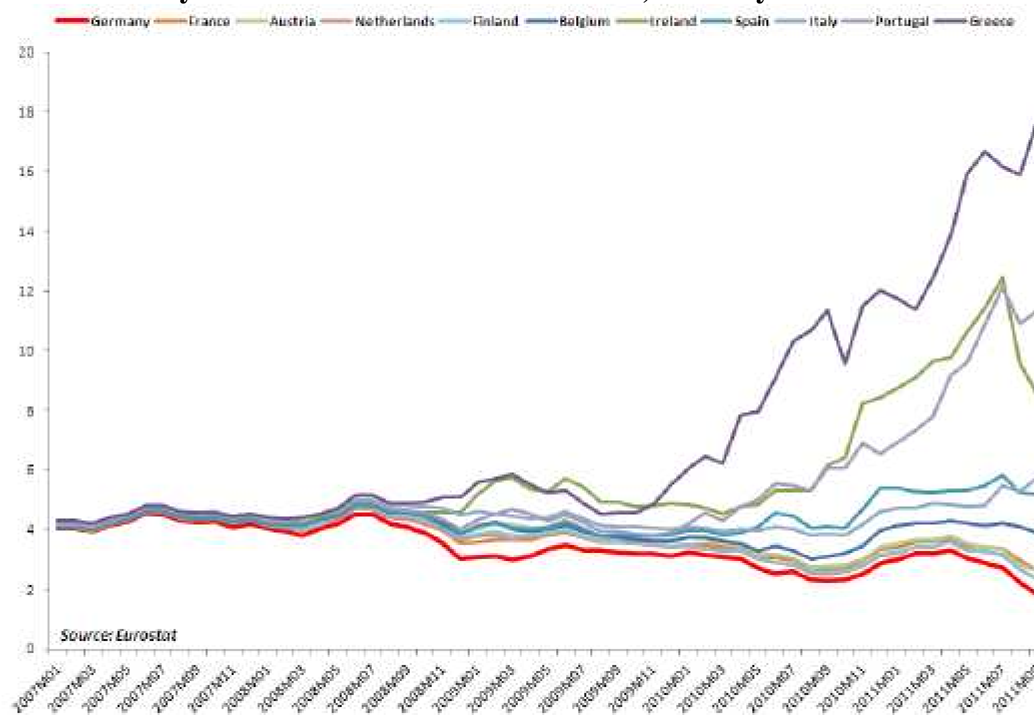
What is very important, the chart shows that although the first signs of the emergence of spreads between yields of bonds of individual countries occurred in 2008, a radical decompression of yields occurred only towards the end of 2009. Thus, this phenomenon was not directly associated with the first phase of the global financial crisis, caused by the collapse of the subprime mortgage market in the U.S., but marked the beginning of an entirely new phase of the crisis, taking place on the public debt market in the euro area.

Figure 2
Yields on 10-year bonds of euro-zone countries, January 1992-December 2005



Source: Eurostat, as per: Jacob Funk Kirkegaard, *The Euro Area Crisis: Origin, Current Status and European and U.S. Responses*, Testimony before the U.S. House Committee on Foreign Affairs Subcommittee on Europe and Eurasia, October 27, 2011.

Figure 3
Yields on 10-year bonds of euro-zone countries, January 2007-October 2011



Source: same as for Figure 2.

What connects the two graphs is the fact that in both periods when investors differentiated the credit risk of government bonds in the euro area, i.e. before 2001 and after 2008, the risk of Greek bonds was clearly rated as the highest. In fact, Greece has become a sort of igniter, which played a critical role in the disintegration of public debt market of the euro area. This process, however, had as much to do with the failure of public finances of Greece, as with the fundamental defects in the functioning of the mechanism of the Economic and Monetary Union (EMU).

1.2. The outbreak of the crisis

Bloated public sector of Greece was for years almost synonymous with waste and corruption. In the years 1990-2009 the average size of its budget deficit exceeded 7% of GDP, while public debt has never fallen below 94% of GDP. The systematic violation by Greece of the criteria for prudent fiscal policies contained in the Stability and Growth Pact (SGP), however, did not cause any disciplinary measures on the part of the EU (the same was true for the other countries). Also, there is no doubt that the adoption by Greece of the single European currency has contributeded considerably - mainly through the radical reduction of interest rates and ensuing credit expansion – to the loss of international competitiveness of this country and the creation of a deep economic imbalances in relations with the rest of the euro area, as shown by budget and current account deficit with foreign countries. This state of affairs for a long time did not raise any major concerns in financial markets, until the consequences of the global financial crisis and recession caused by it have worsened dramatically the situation of the Greek economy.

The shock came on 16 October 2009, when Prime Minister of the new government of Greece Jeorios Papandreu revealed that the state of public finances of this country is much worse than previously claimed - a budget deficit was estimated at this moment at 13.6% of GDP, while public debt at 115% of GDP. For the international bond market it suddenly became clear that the threat of insolvency to the Greek Government is entirely real. To understand the reaction of the market, what occurred afterwards, it must be emphasised that bond investors have distinguished so far very clearly the bonds of governments of developing countries, where quite often there were cases of restructuring, moratoriums and other events that create credit risk, and government bonds of developed countries, where after World War II no disturbance in debt payments has ever occurred and hence debt investors did not suffer any credit losses. As a result, bonds of both these groups of countries were treated previously as separate classes of financial assets. The bonds of developed countries (to which Greece belongs) have the status of absolutely safe assets, which has been "encoded" into the investment policy of financial institutions, as well as into the supervisory regulations.

Insolvency of the Greek government, leading to some form of restructuring of its debt and, consequently, probably also significant problems in the servicing of private debt (including banks), would therefore be an event of historic proportions. However, despite years of neglect and loss of credibility of Greece, this did not have to happen. From the perspective of the European Union and the eurozone, Greece is a small country (2% of EU GDP) and hence it

might be expected, and such was the expectation of financial markets, that it quickly obtains the necessary financial support, as is was frequently observed during the previous two years of crisis in relation to a number of financial institutions.

As subsequent events have demonstrated, however, the fundamental institutional arrangements of the euro area, and disputes among the major countries of the zone regarding their understanding and interpretation, pose enormous obstacles for the effective organisation of international financial aid to Greece, and then also to other area countries. The euro area has proved to be completely unprepared both to prevent and to resolve fiscal crisis in a member country of the zone. As a result, subsequent rescue operations for the peripheral countries of southern Europe were in fact a great improvisation. Specific solutions for each case were created ad hoc during the successive emergency EU summits, notwithstanding the poorly hidden conflicts among the main players in the negotiations, including in particular two dominant euro zone countries, Germany and France, and the EU institutions with the European Central Bank in the key role.

The apparent common feature of the euro zone rescue operations for countries threatened with insolvency was their limited and temporary nature. As a rule, first there was denial of the prospect of insolvency of each successive government, then the necessary action has been delayed, and finally the scale of assistance has been reduced. This playing for time and continuous operation in the style of "too little and too late," caused a dramatic loss of investor confidence in the effectiveness of the actions of authorities of the euro area and their determination to finally resolve the crisis. As a result, virtually any rescue package has met with disappointment of bond market, which quickly led to a speculative sell-off of government bonds of a given country, but then also of those of further ones, recognised by the market as the next candidates for insolvency. This simple mechanism of "contagion" by the crisis of confidence of more and more countries, based primarily on the perception of investors, led the troubles of small Greece turned via a chain reaction into a systemic crisis of the entire euro area.

1.3. Crisis management of public finances in the euro area

The main systemic inconsistency which characterises the construction of the euro area has never been a secret - economists have repeatedly pointed out that it is a political compromise under which the full integration of monetary policy at the European level coexists with almost completely decentralised fiscal and public finance policy. In the formal sense, coherence and stability of public finance policy in the euro area countries should be ensured by rules of the Stability and Growth Pact, as well as comprehensive reporting and corrective action procedures (Excessive Deficit Procedure), but they actually turned out to be fiction. EU authorities do not have any tools to force the sovereign country of the euro zone to conduct its public finances in a responsible way.

Of critical importance is the fact that the philosophy of full fiscal sovereignty of Member States adopted by the Union also extends to the area of public finance crisis. EU Treaties

tacitly assume that the member countries will conduct responsible fiscal policy on their own, and also that the same principle will apply in a possible crisis.

Treaties do not contain any provisions on the management of financial or fiscal crisis in the euro area, and in fact even contain provisions which prohibit the authorities of the Union and member countries from assuming debts of other countries, which is interpreted as a prohibition on financial assistance (so-called "no bail-out clause" in Article 125 of the Treaty). Conservative interpretation of financial aid rules has been adopted in particular by the German government, acting under strong internal political pressure, expressing opposition to a situation in which a country conducting responsible fiscal policy would have to finance the lavish and wasteful spending by its Union partners (the problem of "moral hazard, or “transfer Union ") .

As a result, in the first rescue package for Greece of May 2, 2010, which was being conceived in pain for many months, the part of the EU (EUR 80 billion) consists of bilateral loans from member countries, only administered by the EU. It was in the period between October 2009 and May 2010, when the helplessness of euro area regarding the problem of Greece was fully revealed, that the bond market began to sharply differentiate between the credit risk of individual countries of the area: premium of Greek bond yields over German ones in this period increased from 140 to over 600 basis points.

The negative market reaction to a package of 2 May 2010, almost immediately forced the EU to take more ambitious, though still limited steps. On 9 May 2010, the decision was announced to put together another financial package, this one designed expressly for the prevention of "infecting" successive countries with crisis. A joint package of the Union and the International Monetary Fund amounted to EUR 750 billion, and its main ingredient was a fund of member countries of the euro area, created to assist the countries in crisis, called subsequently the European Financial Stabilisation Facility (EFSF).

The EFSF has a complicated legal and financial structure. It is not strictly speaking an EU institution, but the company set up by the governments of 16 countries of the euro area. Bonds issued by EFSF are not subject to total and several guarantee of the founders – standing of those bonds depends on the ratings of governments of founding countries in the proportions set by their shares in EFSF equity, so even though at the time of the creation of the fund it received AAA rating, uncertain financial situation of some of these countries means that the threat of a loss of this highest rating by EFSF is treated by the market as quite probable.

The maximum lending capacity of EFSF, which it is expected to achieve over the 3-year period of its operation, was set at EUR 440 billion, which at this early stage of the crisis seemed to be sufficient. The process of "contagion" with the crisis of successive countries has quickly verified these assumptions, especially from the moment when Spain and Italy found themselves in the danger zone - size of EFSF needed to calm the market was then assessed at EUR 3 to 4 trillion. However, so far resources of EFSF have not been enlarged, but discussions on ways to increase its lending capacity and credit instruments it could use have become an integral part of debates on the crisis in the euro area.

1.4. The European Central Bank and the debt crisis in the euro area

The inconsistency of systemic design of the euro area, which has been dramatically highlighted by the debt crisis, also expresses itself in the limitations imposed by it for the European Central Bank's activities in the area of macroeconomic stabilisation. The European treaties adopted the principle of the categorical distinction of the sphere of monetary policy, which is the domain of the ECB, and public finance policy, which is the domain of governments. In particular, the ECB may not finance the governments of the Member States of the euro area, or "monetise the public debt," which according to a conservative interpretation adopted by the management of the ECB imposes very severe restrictions on its operations in the government securities market in euro zone countries.

In the world of banking, for a long time is used to be the practice, that in the state of crisis, central banks undertake intervention in the financial markets, providing liquidity to markets and prevent drastic decline in prices of financial assets. This is of paramount importance for the psychology of the market, because the central bank – as the institution creating the reserve money for the banking system - has for the purposes of stabilisation virtually unlimited financial resources. Even if in the classical sense this kind of central bank intervention takes place mainly in the money market in respect to banks, it was also repeatedly used in the capital market (in the current crisis, for example, such actions have been performed by the Federal Reserve System and Bank of England).

Many representatives of the financial circles and observers of the crisis in the euro area are of the opinion that a definitive, or even the only way to overcome investors' current psychosis and to gain control of the situation on the securities of euro area countries, would be for the ECB to undertake regular purchases of bonds of the governments threatened by the crisis, in order to keep their prices at the desired level. However, from the very beginning of the crisis management of the ECB categorically opposed to this kind of policy, citing legal restrictions, but also expressing skepticism about the long-term effectiveness of intervention in the bond market. One can believe that the main reason for the conservative policy of the ECB is striving to avoid a "moral hazard", i.e. a situation in which the countries leading irresponsible fiscal policy could continue to do so without hindrance on the part of the financial market, which in turn would undermine the effectiveness of monetary policy of ECB.

Under the pressure of events in the market, the ECB has been only partially forced to move away from its fundamental attitude. As part of a rescue package of 9 May 2010, the ECB announced a bond purchase program (Securities Market Programme, SMP) and started buying periodically the securities of countries suffering from, or threatened by the crisis. The purchases of ECB, however, have only a limited scale, and the bank itself has often publicly emphasised that their goal is solely to maintain the necessary liquidity for the market and thus to provide the conditions for an effective interest rate policy, but in no case this is the systematic intervention on the public debt market aimed at stabilisation of bond yields. According to the ECB, this last task belongs exclusively to governments. Naturally, such a situation deprives the ECB interventions of any psychological impact on the market - they are

not the factor increasing confidence and inducing investors to buy bonds, but rather help them out of the market.

The effect of the ECB's lack of support for the public debt market of euro area countries during the crisis is a rather paradoxical situation, in which the government bonds of countries of euro zone took on the characteristics traditionally associated with the bonds of developing countries. The latter do not usually have well-developed bond market, so in large part are forced to borrow abroad. Because they are not able to control the source of repayment in foreign currency, the risk of disturbances in the debt service is quite high here. On the other hand, governments of developed countries borrow primarily on the domestic market in their own currency, which means that in a major crisis they can stabilise the public debt market with the help of the central bank. It is this possibility that has contributed largely to give bonds of developed countries the status of assets free of credit risk. But during the course of the current crisis, investors realised the hard way that in the bond market of the euro area countries, the above mentioned rule is not applicable.

This thesis is confirmed by the behavior of investors in the bond markets of the United States, Britain and Japan during the current crisis. Although these countries have the main indicators of the fiscal and public debt situation worse than many euro area countries, international investors not only don't not lose confidence in their bonds, but even treat them as a "safe haven" for their investments, which led to a decline in the yields of their Treasury bonds to record low levels. The often-heard explanation of this behaviour is an active support for the market of public debt in these countries provided by central banks.

2. The banking crisis in the euro area

The chronic banking crisis which the euro zone is currently undergoing, is like a "twin" to the public debt crisis. Both of these crises not only overlap and mutually intensify, but they also exhibit several common features. The most important similarity between them is a fundamental loss of trust - in this case, the loss of faith of investors and other creditors of banks in financial stability of the banking sector a number of countries of the zone. Again, the breakdown of trust is largely derived from the observation that the euro land does not have the institutional process and tools for effective crisis prevention and for management of such a banking crisis, when it does occur. As in the case of public finances, in practice the management of the banking sector crisis has proved a task that in "the moment of truth" fell primarily on the shoulders of governments and supervisory bodies of the Member States, as the authorities of the euro area (EU) had neither appropriate procedures nor financial means.

2.1. The legacy of the banking crisis of the years 2008-09

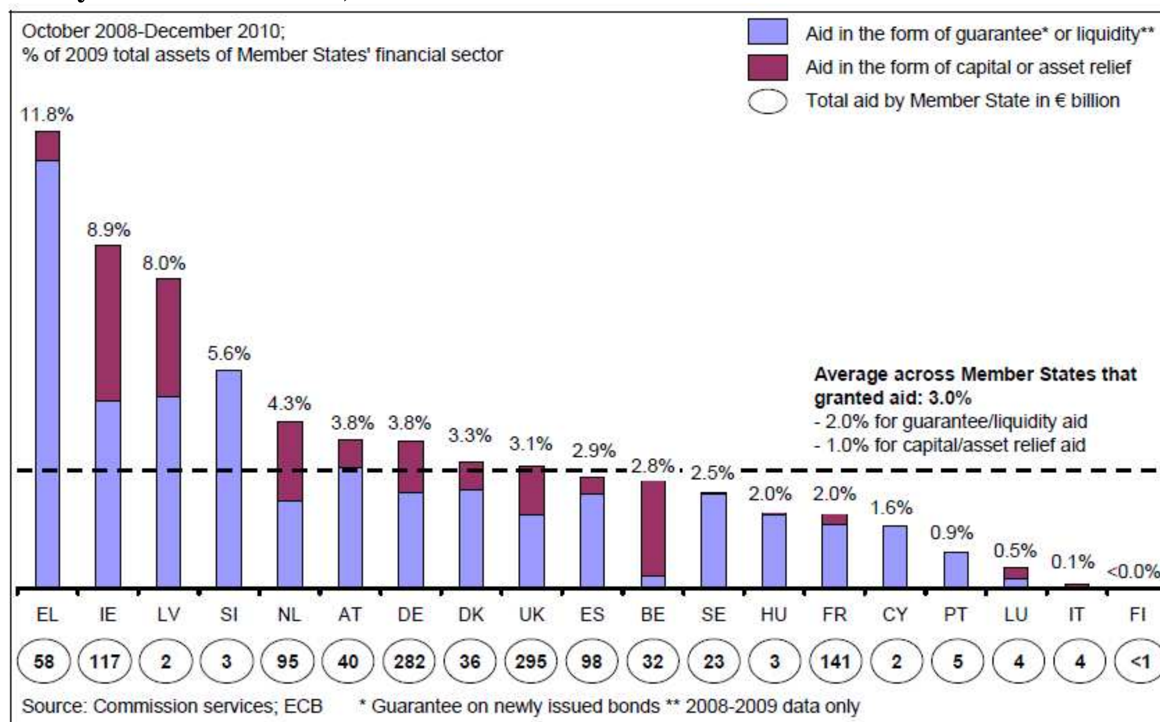
The current crisis in the public debt sphere has affected banks of the euro area in a situation where they still feel the far-reaching consequences of the earlier phase of the global financial crisis of years 2008-09. In the previous installment of the crisis European banks have suffered very serious losses, but due to the complex and phased-out process of accounting for these losses, only a portion of them has been revealed so far in their books, and thus found a reflection in the capital of banks. Banks in Europe have managed in recent years to strengthen significantly their capital base, to a large extent due to a very prominent public aid, but the problem is that among their assets there are still very serious risk concentrations, the scale and probability of loss of which can only be estimated.

The chronic banking crisis which the euro zone is currently undergoing, is like a "twin" to the public debt crisis. Both of these crises not only overlap and mutually intensify, but they also exhibit several common features. The most important similarity between them is a fundamental loss of trust - in this case, the loss of faith of investors and other creditors of banks in financial stability of the banking sector a number of countries of the zone. Again, the breakdown of trust is largely derived from the observation that the euro land does not have the institutional process and tools for effective crisis prevention and for management of such a banking crisis, when it does occur. As in the case of public finances, in practice the management of the banking sector crisis has proved a task that in "the moment of truth" fell primarily on the shoulders of governments and supervisory bodies of the Member States, as the authorities of the euro area (EU) had neither appropriate procedures nor financial means.

Across the European Union, the used state aid to banks amounted to an average of 3.0% of EU banking sector assets (see Chart 4). The scale of support for the banking sector – taking into account both absolute and relative dimension - differed significantly among countries. In the case of euro area countries, the biggest beneficiaries were the banks in Germany (EUR

282 billion) and France (EUR 141 billion), representing 3.8% and 2.0% of banking assets in these countries, respectively.

Figure 4
Use of public support for the EU banking sector (% of assets of the banking sector of the country at the end of 2009)



Source: European Commission, Staff working paper, *The effects of temporary State aid rules adopted in the context of the financial and economic crisis*, SEC(2011) 1126, 5.10.2011.

The situation in the peripheral countries of the euro area was varied: the biggest assistance, both in relative and absolute terms, was given banks in Ireland and Greece (EUR 117 and EUR 58 billion, respectively) – banking crisis was especially devastating in Ireland, where the banking system engaged on a large scale in the financing of real estate speculation, and public support for the banks caused the collapse of the budget and was the main cause of Ireland applying for international assistance. On the other hand, assistance to banks was relatively small in Portugal, and regarding the large southern countries, in Italy.

To understand the course and consequences of the banking crisis in the euro area, of paramount importance is the fact that public support for banks was organised and funded primarily by governments and bank regulators of the Member States, since at the moment of an outbreak of an acute banking crisis it became clear that the EU and the euro area practically did not have any means of action. Contribution of the EU to the bank support consisted chiefly in establishing the uniform guidelines for aid, formulated in the context of a control of state aid and protection of competition (!) - so these actions were implemented to a degree beyond the traditional realm of banking supervision activities. On the other hand, it must be emphasised that the rules of aid have been defined very quickly by the standards of the EU (decisions taken on October 12, 2008), and conditions for granting aid to the individual banks approved by the European Commission were often very harsh and forced on

the banks the authentic restructuring and / or change of business strategy. It is worth mentioning that the aid was quite heavily concentrated in large banks - among the leading financial groups operating in Poland, one can mention Commerzbank, ING and KBC.

About a third of used public assistance to banks in the EU was used for recapitalization of banks, directly or indirectly (through guarantees for the value of assets). Although the banks have sought to strengthen their capital through the issuance of new shares and retained earnings (non-payment of dividends), the scale of the necessary provisions to reserves and for impairment of assets in trading books was so great that they came out of the acute phase of the crisis at the turn of 2008 and 2009 with very weakened financial position. Concerns about the stability of the banking sector in many European countries have been augmented by the fact that banks have been often unable, or unwilling to completely "clean" their balance sheets from all sorts of toxic assets. This is due in large part precisely to the weakness of banks' capital - the sale of assets at depreciated market price or the creation of reserves for the whole exposure would be simply too expensive, so banks are forced to keep the distressed assets on the balance sheet at artificially inflated valuations.

Accurate information about the risky bank assets and their valuation is still difficult to obtain, despite the efforts of supervisors to increase the completeness and transparency of data on the financial position of banks. The generally established opinion is that American banks attempted much more rigorously to put their balance sheets into order than banks in Europe, as a result of greater pressure regulators, as well as more stringent market standards in force in the U.S.

According to a recent report from Credit Suisse, the largest banks in the United States have written down on their balance sheets over 80% of the value of "toxic" assets from the first phase of the financial crisis, while for major European banks this proportion amounts only to about half (data as of 30 September, 2011). According to the same report, 16 leading European banks had yet at this moment the "old" and difficult to value distressed assets (loans and bonds secured by mortgages, CDOs and other structured instruments, etc.) for an amount of EUR 386 billion. Most of this amount consists of assets on the balance sheets of the largest banks in the UK, Germany and France, and for some of them these assets are greater than the amount of Treasury securities of euro area countries affected by the crisis of public finances.

2.2. Direct effects of public debt crisis for banks in the euro area

Generally speaking, the public debt crisis struck in the euro area banks in a similar manner as the earlier disturbances in the years 2008-09. It caused the actual bank losses, reflecting the current deterioration in the valuation of assets, and intensified the lack of confidence in the stability of the banks by increasing the uncertainty as to possible future losses on assets held. Banks in the euro area countries are very significant investors in Treasury bonds issued by Member States, so the decline in market prices of bonds of the countries affected by crisis, coupled with the prospect of incurring serious credit losses in the event of eventual restructuring of the debt (in the case of Greece banks have so far written off up to 60% of their portfolios) has now become a key additional element of systemic risk in the banking

sector eurozone. The scale of the total possible losses arising from the depreciation of assets (either in relation to market or credit risk) is again so large that in the case of many banks it can cause total destruction of their capital, hence the problem of insufficient capitalisation of the banking sector once again found himself at the centre of attention.

According to estimates of the analysts of Brussels think-tank Bruegel, at the end of 2010, the total amount of government debt of Greece, Ireland and Portugal amounted to EUR 620 billion (face value), of which domestic banks held bonds totaling EUR 109 billion, and banks from other countries of euro zone held bonds amounting to EUR 87 billion (see Table 1). Furthermore, the ECB possessed the bonds of these 3 countries amounting to EUR 93 billion.

Of course, if you take into account the debt of these countries' private sector to banks in the euro area, the scale of exposure of these banks is growing rapidly (Table 1 shows besides the public debt, also the assets of banks in the euro area towards banks in Greece, Ireland and Portugal). If you further take into account in the analysis the subsequent countries under the real threat of public debt crisis, and also having a much bigger debt, such as Spain or Italy, the scale of risk increases in an exponential manner.

Table 1
Estimate of the amount of debt of governments and banks in peripheral countries (EUR billion as of end 2010)

	Greece	Ireland	Portugal	Spain	Total
Total government debt (at face value)	325	153	142	677	1297
of which held by :					
Domestic banks	68	11	19	227	336
Rest of euro-area banks	52	14	33	79	166
Other banks	6	9	5	24	43
Non-banks (both domestic and foreign)	119	97	64	347	627
ECB	50	22	21	0	93
IMF, EU and official lenders	32	0	0	0	32
Ratio of average market value to face value of government debt	0.75	0.85	0.9	1	
Foreign banks' exposure to national banking systems	10	119	43	209	381
of which euro-area banks	6	66	37	154	264
Eurosystem lending to banks	95	132	41	65	333

Source: Zsolt Darvas, Jean Pisani-Ferry, Andre Sapir, A Comprehensive Approach to the Euro Area Debt Crisis, Bruegel policy brief, Issue 2011/2, February 2011.

It should be emphasised that both in the case of toxic assets acquired in an earlier phase of the crisis, and of the "new" assets related to the public debt crisis, the problem consists of potential losses that could ultimately not realise at all, or realise only in part. However, these assets are at real risk of heavy losses, hence the resulting threat to the stability and solvency of the banks has immediate, highly negative consequences for them:

- it causes pressure for a decline in banks' stock prices, which worsens the attractiveness of issuing of new shares from the perspective of banks and reduces the interest of investors in shares of banks, which limits the ability of banks to strengthen the equity capital in this way,
- it leads to the weakening of the financial standing of banks in the markets for debt instruments (it is often accompanied by a formal downgrade of credit rating), which raises the

cost of funds obtained by banks in the money and bond markets, and in the case of banks from countries at risk of insolvency and covered by international assistance programs, even makes it impossible for them to access those markets.

Naturally, to the extent that banks make a reliable estimate of potential losses, and as a result adjust the valuation of assets accordingly or make appropriate provisions for expected losses, a negative effect on the financial result and capital follows immediately. From the perspective of financial markets, this has the advantage, as it helps to reduce uncertainty among investors. The problem is that the approach of banks (and one should add, also that of supervisors from various countries) to the above issue is still not uniform and very opaque, so this factor is in itself a significant element of uncertainty.

As one can see from the above, the mere uncertainty in financial markets associated with the prospect of significant losses of banks results in increasing funding costs and reduced profitability of banks, severely limits the possibilities of banks operating in business lines that require a high standing, and generally undermines the growth prospects of the banking industry.

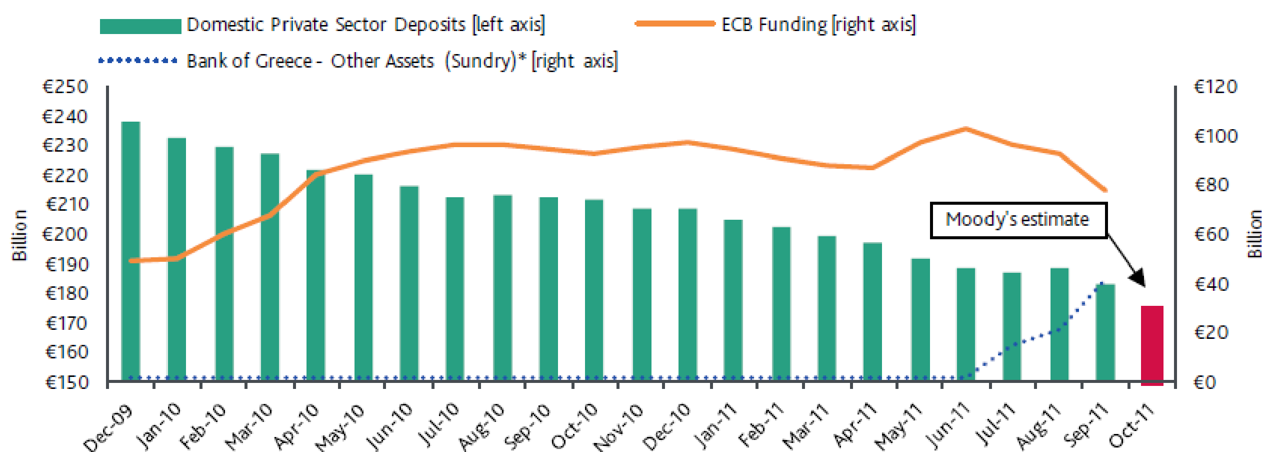
The impact of the crisis of confidence on operating conditions of banks from the particular euro area countries, or even on the situation of individual institutions, depends of course on the specific circumstances. Undoubtedly, the most difficult is the situation of banks from the three peripheral countries of the area (Greece, Ireland and Portugal), that following the public debt crisis and the "contagion" of banks with the risk of their own state, have lost access to wholesale money and bond markets. Moreover, in the case of Greece and Ireland, there was also a systematic outflow of customer deposits from banks, forcing them to use to a growing degree the liquidity assistance programs of their central banks (with government guarantees), or direct financing from the ECB.

As an example, Figure 5 shows the main sources of funding for banks in Greece during the crisis. It shows the unnatural situation of Greek banks, which in September 2011 had deposits of EUR 183 billion (a decrease from EUR 209 billion at the beginning of this year), while at the same time having EUR 78 billion of debt with the ECB and the EUR 27 billion debt with the central bank. In the long run this trend is not sustainable, due inter alia to the Eurosystem's collateral requirements, which determine the effective limits for liquidity assistance. These requirements can obviously be relaxed, and it has already been done, but it is difficult to expect that the ECB and national central banks may completely abandon their own credit risk management.

Problems with access and cost of financing that are suffered by banks from peripheral countries, are naturally much greater in comparison with banks in other euro area countries. However, also the banks from the entire euro zone have periodic trouble with the normal funding on wholesale financial markets. In the summer of 2011 it was visible both in the money markets and bond markets. In the money market, one subject of concern for investors became particularly the French banks, which have experienced increasing difficulties in

obtaining short-term dollar funds (this mini-crisis was averted by the concerted action of central banks in September).

Figure 5
Profile of Greek banks' funding, 2009-2011



* Includes ELA funding for Greek Banks
Source: Data from Bank of Greece, as per: Moody's Investors Service, *State Guarantees for Greek Banks Are Credit Negative; Point to Further Funding Deterioration*, Weekly Credit Outlook, 14 November 2011.

In turn, in the capital market, through a few months' period the banks virtually ceased to issue classic unsecured bonds (among others things, due to their very high cost) and limited themselves to offering lower-cost secured bonds. But here again there is a restriction in the form of shrinking supply of collateral of acceptable quality to investors that banks possess. The problem of banks having the possibility of refinancing in the bond market is quite serious because in the coming years the maturities of large bond issues sold by banks in previous years will start coming to maturity (particularly important year is the 2012, when the maturity of over $ 800 billion of bonds will fall, including a lot of cheap issues placed by European banks in the years 2008-09 with government guarantees). The effect of above is a weakening credit standing of European banks in the bond market and hence the rising cost paid by the banks. This process is illustrated in Figure 6 – the indicator of standing here is an implied rating, calculated on the basis of the market cost of bank bonds.

Difficulties with the current financing of the activities by European banks in the money and bond markets are part of another negative feedback, which was produced over a period of crisis - these troubles hit banks' profitability through the increased cost of funding, leading to pressure on the prices of their shares, and complicating the solution of the more fundamental problem, namely strengthening the banks' own capital. According to Moody's estimate of the beginning of November, European bank shares were traded at this point at an average level corresponding to approximately 50% of their book value.

Figure 6
Rating of European banks implied by the prices of their bonds

Source: Moody's Investors Service, *A Challenge at the Wrong Time: European Bank Financing Needs Are Set to Peak as Market Conditions Worsen*, Weekly Market Outlook, November 10, 2011.

2.3. The problem of bank recapitalisation

While the need to recapitalise the banks in Europe generally does not raise doubts, is a question of quantifying the size of necessary recapitalisation and finding sources of new capital that are the subject of heated debate and controversy. These discussions are in part a consequence of the very difficult economic and financial environment, which evidently hampers effecting a recapitalisation in the most beneficial way for the European economy, namely by increasing banks' capital through issues of new shares and the capitalisation of retained earnings, and at the same time, without restricting lending, which is very important for economic growth. A significant increase in capital, however, would reduce leverage in the balance sheets of banks, and hence cause the decrease in return on capital, which is the primary measure of assessing performance of the banks by investors.

As a consequence, the boards of banks are not at all enthusiastic in respect of the expansion of capital, and because the issue of capitalisation has, in fact, a relative dimension – what's important is the relationship between assets and equity - one can now often meet with the statements of representatives of the banking industry who suggest that the strengthening of capital buffer will be achieved (in the relative sense) by slimming banks' balance sheets rather than by increasing the capital. There remains of course the option to carry out the recapitalisation by the public sector, but the boards of banks treat this option as an absolute necessary evil, because this would entail increased control of banks by politicians.

The controversy surrounding the recapitalisation is made particularly acute by the fact that the debate on this subject takes place in the context of new regulatory and supervisory requirements, which are being introduced following the banking crisis of 2008-09 year. As is

well known, the most important of these regulations is the so-called Basel III package, developed by the Basel Committee of Banking Supervisors (BCBS) and implemented in the countries of the European Union by CRD IV legislation. Basel III dramatically increases the international standards of capital adequacy, which is a completely understandable step, given the necessity to reduce risk in the banking activities in view of the crisis experience from the years 2008-09. Differences of opinion focus above all on the scale of the increased capital requirement and its consequences for banks and the global economy. According to various estimates, Basel III effectively raised 2-3-fold the amount of requirements for core capital, which is a result of a simultaneous tightening of the definition of regulatory capital, increase in the risk weights for a number of exposures (assets) and increase in the capital adequacy ratios.

The international banking industry, and in particular the largest transnational banks, which are to be covered by the additionally increased capital requirements, demonstrate a clear reluctance towards Basel III. In the public debate the industry primarily use the argument that such a large increase in capital requirements will result in a significant increase in the marginal cost of funds for banks (because the cost of capital is higher than the cost of debt), which will translate into a higher cost of credit, and consequently into a decrease in credit expansion and finally will result in a global economic slowdown. This argument is undermined by the supervisors, whose analyses indicate that this effect is almost completely compensated by positive effects of increased macro-financial stability. Both parties publish significantly divergent results of their analyses on this subject, and so far, remain in their own mind.

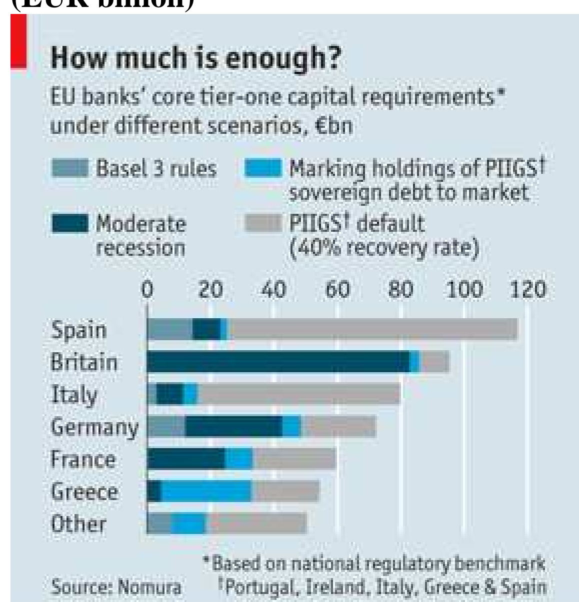
The whole debate on Basel III takes place on the assumption that the implementation of its provisions will be phased out over several years - BCBS planned full implementation of capital and liquidity standards by the year 2019, which as originally thought out, should give banks enough time to gradually build capital base. But the current reality of the capital market has imposed on banks different rules of the game - a crisis of confidence in the markets is so deep that investors expect from banks that they have reached a safe capital buffers already in the next 2-3 years. At the same time, however, investors expect that banks will achieve an appropriate return on equity, defined as at least 12% (this is the estimated cost of equity for banks). The combination of high expectations of regulators regarding capital ratios and expectations of investors regarding the return on equity creates the risk that the banks meet these expectations primarily by reducing lending, which of course would be completely contrary to the assumptions of banking supervisors.

The confusion that accompanies the debate about the possible and required capitalisation of banks has been further complicated by the public debt crisis in the euro area. In fact, discussion is now not so much about whether, or not only about whether, banks will be able to absorb losses associated with possible restructuring of debt of peripheral countries, but whether they would be able at the same time to cover these losses and also meet the requirements of Basel. In this situation it is not surprising that the estimates of necessary new

capital needed by the banks in Europe, that are given in the discussion, differ by a huge amount - it all depends on what scenario and on what assumptions they are based.

Figure 7 gives some idea of the scale of amounts discussed and complications in the creation of possible scenarios. As follows from the calculation of analysts Nomura Securities, the fulfillment of the requirements of Basel III would at present require banks from the EU countries to obtain over EUR 100 billion. But adding to this amount the assumptions about a moderate recession in Europe and the valuation of public bonds of 5 PIIGS countries at market prices raises new capital required to almost EUR 300 billion.

Figure 7
Estimate of the new capital required for banks in the EU under different scenarios (EUR billion)



Source: Nomura Securities, as per: The Economist, Holey grail – How much capital do lenders need?, October 1, 2011

2.4. EU supervisors and the banking crisis in the euro area

One factor that in recent time significantly increased the nervousness of investors on the question of necessary capitalisation of European banks was ambiguous approach to the problem by banking supervisors of the EU. Similarly to the public debt crisis, EU institutional arrangements proved to be totally inadequate for the task of dealing with the banking crisis. To be precise, it must be emphasised that the weakness of the EU supervisory arrangements is in large part associated with leaving a significant role in matters of banking supervision to national regulators, due to which the actions taken by the EU authorities lose the coherence and effectiveness. This is clearly shown by the comparison of approaches taken in respect of bank recapitalisation by the United States and the Union.

According to a fairly common opinion, a very dangerous financial crisis that erupted in the United States in September 2008 following the bankruptcy of Lehman Brothers, was

effectively contained in the spring of 2009, largely as a result of two actions carried out by the authorities: the program of capitalisation of banks, TARP (Troubled Asset Relief Program), funded from the budget and directed by the Treasury Department, and the stress test for the 19 largest banks carried out by the Federal Reserve System (SCAP program, Supervisory Capital Assessment Program).

In the context of calming the mood and restoring confidence in banks, a very important role was played by SCAP stress test, due to the credibility of the methodology and assumptions, full disclosure of the results of individual banks and, perhaps most importantly, the general conformance of results with market expectations. What is also very important, the stress test was followed by very concrete actions, and so the banks with insufficient capital had to be raised in the short span of time.

Positive effects of the U.S. stress test prompted the EU authorities to use the same tool, but its use and effects proved to be quite different. The first European stress test was carried out as early as 2009, but it has played virtually no role in managing the crisis, since only a very limited, aggregate information was made public. Two further stress tests, however, the 2010 and 2011 ones, have attracted close attention of financial markets, as they occurred during the growing debt crisis, and as expected by the markets, they had to answer the question of how the banks of the European Union would be able to withstand the consequences of crisis. In both cases, however, the outcome was very disappointing, because it the results were very divergent compared with analysts' estimates, and subsequent events fully confirmed that it was the market that was right. Instead of calming the moods, lack of credibility of official results of stress tests deepened in effect the general crisis of confidence.

The approach to both stress tests by the supervisor of the EU (in 2010, the Committee of European Banking Supervisors, CEBS, and in 2011, the European Banking Authority, EBA) reflected all the constraints that resulted from its limited role as a "politically correct" coordinator of the exercise carried out mainly by national supervisors. General assumptions adopted at the European level in principle ruled out the possibility that stress test shows the full extent of risk borne by banks. While capital market analysts assessed the capital needed to cover losses from an adverse scenario for tens or even hundreds of billions of euros, the EU stress test painted a rosy picture of the crisis: for the overall sample 91 banks in both tests, in 2010 the required level of capitalisation was not reached by only 7 banks with total deficiency of EUR 3.5 billion, and accordingly in 2011, 8 banks with EUR 2.5 billion deficiency! Good results were obtained by the banks that soon after the stress tests went virtually bankrupt: in 2010, Allied Irish Bank (received capital injection from the government), and in 2011, Dexia (thoroughly restructured by the governments of France and Belgium). Only three months after the publication of test results in 2011, in the re-calculation of bank capital required as part of the revised aid package for Greece, the EBA received the result of over EUR 106 billion.

Summarising the remarks on EU banking supervisors, it should be added that the process of shaping the post-crisis structures and processes of regulation of the financial system is still far from completion. An important step is for sure the reorganisation of structures of supervisors

in accordance with the recommendations of the so-called De Larosière Report of 2009 and the transformation of the existing committees of a coordinating nature into supervisory authorities with greater powers and responsibilities (in the banking sector, the CEBS was transformed into EBA).

Regarding the process of creating the legal and institutional foundations for the prevention and management of banking crises, including rules for dealing with banks at risk of bankruptcy, it passed the consultation stage in spring 2011 and is expected to result in the European Commission's legislative proposal before the end of this year,. In this context, one of the more controversial issues to investors is a preliminary proposal to give an EU regulator the right to convert bonds of the rescued bank to its shares and / or to effect a deduction from the bank's bonds to cover losses.

3. The financial crisis in the euro area and the Polish banking sector

According to classic criteria and principles of the analysis of financial crises, international financial crisis of the years 2008-09 (in its European elements) essentially bypassed the Polish banking sector. In particular, if we take for a measure of power of the crisis the scale of effectively provided and utilised public assistance that proved necessary to ensure the normal functioning of banks and the stability of the whole sector, it can be concluded that the crisis in Poland did not happen. Strictly speaking, the Polish parliament, the government and central bank have taken several steps aimed at ensuring the financial stability of the country (inter alia, the Act on the provision of State Treasury support to financial institutions was adopted, the program of government guarantees and recapitalisation program for financial institutions were prepared, the NBP took steps to help stabilise the money and foreign exchange markets), but most of these instruments did not have to be used at all.

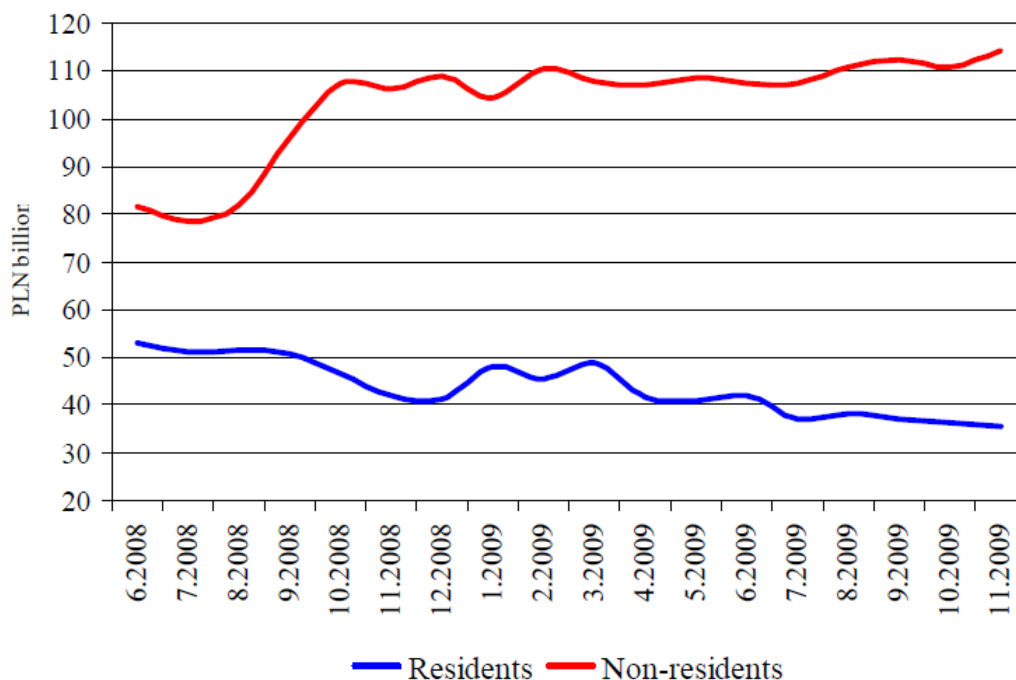
One can point to several reasons for a large resilience of Polish banking sector to the global crisis: good Polish economic situation at the outbreak of the crisis, a strong capital position and financial standing of Polish banks resulting in part from their traditional business model (lack of risk concentrations arising from involvement in complex structured finance instruments), and finally the ability of Poland to conduct an independent monetary and exchange rate policy within the national monetary system.

However, the categorical view of a complete lack of impact of the global financial crisis on the Polish banking sector would be significantly over-simplified. On a closer analysis it is visible that, while in Poland there has been no severe disturbances in the functioning of financial markets or risk of collapse of financial institutions of systemic importance, the degree of integration of the Polish banking system with European or global market is already so strong that a systemic disorder abroad must have a impact on the functioning of banks in Poland.

As it seems, one can point to at least three channels through which the international situation influences the Polish banking sector:

- The macroeconomic situation: if the financial problems in the euro area have a negative impact on the real economy in Europe, the recessionary impulses move also to Poland through the channel of foreign trade, direct investment, etc. The slowdown in growth leads in turn to a start of the downward phase of the credit cycle: we can see an increase in credit risk, deterioration in quality of the credit portfolio of banks, tightening of lending policies by banks and finally decline in lending. Data on the dynamics of credit growth in the Polish banking sector confirm that in the years 2008-09 such a process had actually taken place in Polish bank - there was a marked decline in the loan portfolio growth and a decline in the profitability of banks associated with the cyclical increase in provision for reserves,
- The methods of financing the activities of banks in Poland: the Polish banking sector has a regular net liability position towards foreign banks, mainly due to the financing of their activities by parent banks, and this indebtedness forms a significant component of total sources of funds for the Polish banking sector. In this way, banks in Poland indirectly receive the funding, which ultimately is raised in significant part on the global money and bond markets within the integrated management of assets and liabilities of their parent groups. Disorders occurring in these markets may therefore easily affect the interbank transfer of funds to Poland. Concerns about the threat that the global crisis could cause a serious blockage of financing of banks in Poland on the part of their parent institutions were very serious in the years 2008 and 2009, but have proven absolutely not true. What's more, during the peak of the global crisis, towards the end of 2008, foreign banks have increased their engagement in Poland by nearly 40% (an increase of 27.1 billion zlotys between August and December 2008).

Figure 8
Liabilities Polish banking sector to domestic and foreign financial institutions during the crisis (billion zl)



Source: W. Koziński, *The international banking crisis and domestic financial intermediation: the experience of Poland,* [w:] Bank for International Settlements, BIS Papers No 54, The global crisis and financial intermediation in emerging market economies, December 2010.

Maintaining a stable funding for Poland and other countries in the region during the crisis was the subject of a specific aid package (Joint IFI Action Plan, or so-called Vienna Initiative of 27 February 2009), which was organised by three international financial institutions - the World Bank, European Investment Bank and European Bank for Reconstruction and Development - in close cooperation with the European banking groups operating in Central and Eastern Europe. Through these groups, using the framework of the Vienna Initiative, the region's banking systems have received during theoperation of the program (until the end of 2010) the amount of EUR 28.6 billion, of which Poland accounted for EUR 1.8 billion. It seems that the initiative of Vienna, although not very large in quantitative terms, played a very positive psychological role in calming the fears of financial circles of a possible "contagion" of central Europe by the financial crisis.

In fact, the only permanent structural change in the mechanisms of financing of the Polish banking sector, which was caused the financial crisis of the years 2008-09, is a contraction in turnover in the interbank lending market and the consequent decline in the importance of this instrument in Polish banks' liabilities. An important reason for this state of affairs is a reduction in transaction limits introduced by the parent banking groups during the crisis.

- The structure of the banking industry in Poland, with particular emphasis on the ownership structure: like in the other countries in Central and Eastern Europe, foreign financial groups control the majority of large banks operating in Poland, hence the events affecting the parent groups (capital injection by the government, restructuring program, the increase in costs or

loss of access to market financing) will inevitably spread to their Polish affiliations, although in an indirect way. A possible impact could take the form of a change of business strategy on the Polish market, such as the slowdown in lending, restructuring of the group in Poland, or finally a change in ownership.

The most spectacular manifestation of the impact of crisis in Europe on the structure of the Polish banking sector are undoubtedly the acquisitions of leading banks, resulting from the restructuring or changes in the strategy of their parent groups. As examples of this type of transactions one may indicate the acquisition of BZ WBK by Santander group from Allied Irish Bank, and the acquisition of Polbank by Raiffeisen group from the Greek Eurobank EFG, as well as the announced sales of Millennium Bank by the Portuguese BCP and of Kredyt Bank by the Belgian group KBC. In each of these cases the sale resulted from a forced restructuring of the parent group caused by the crisis.

It seems that the impact of the current phase of the crisis, with its dominant focus on market for public debt in the euro area, on the Polish banking sector should in principle look like in the first stage of the crisis. If you exclude the worst scenarios, such as the financial panic on a scale similar to the September 2008 or the collapse of the euro area and with all the attendant financial shocks, the most likely potential threat to Polish banks is above all the economic recession in the euro area and its negative impulses for the Polish economy.

In coming years, the big unknown remains the general financial and capital position of the financial groups that control the leading banks in Poland (UniCredit, ING, BNP Paribas, Credit Agricole, Commerzbank), not only in the context of the current problems with the funding in the capital markets, but also in connection with perspective of capitalisation. If the crisis in the public debt market continues and attacks the successive countries, one must be prepared for very large losses of these banking groups and for the need to recapitalise them by the governments or the EU fund, if one is created.

Financial problems of the parent groups are, of course, a potentially negative factor from the standpoint of their Polish affiliated banks, since they mean that the latter have reduced chances for a capital or financial support necessary for their development. The weakness of the parent groups may also result, for example, in the lower credit ratings of Polish banks.

However, in the longer-term perspective, assuming that economic and financial situation of Poland remains stable, the problems of parent groups would mean that the relative position of Polish banks within the international groups should be strengthened. This trend may even lead to a return of Polish banks to complete "independence”, provided of course that in any takeover the role of buyers would be taken by Polish investors and not the other foreign groups.

4. Suggested issues for discussion during the e-debate

This paper is intended to serve as the voice of opening a discussion on the financial crisis in the euro area and its possible consequences for European and Polish banking sector. The author did not seek to formulate his own assessments or forecasts, but focused on preparing the “playing field” for the discussion. For this purpose, the list of some important questions or problems to solve that arise in connection with the analysis of the financial crisis in the euro area, has been elaborated. This list is shown below. It is not a closed list course and should be treated as a loose suggestion - it does not restrict in any way the freedom of the experts invited to the e-debate to raise other issues.

(1) what is the most likely long-term scenario of further developments in the European financial system - whether the eurozone will survive?

(2) what is the optimal approach to resolve the crisis, given the convolution of two "twin" crises, banking and public finance? Should one look for all-encompassing solutions, or treat separately the two crises? Which one of them should be dealt with first (in default, which is the "original" one in relation to the other)?

(3) whether the responsibilities of central bank of the euro zone should be extended to the task of promoting macroeconomic stability, including stabilisation of the market in public debt securities?

(4) if we accept the assumption that in order for euro area to survive, management of public finances and banking supervision across the area must be radically centralised, what are the limits of centralisation of decisions at European level? Whether and how much of the sovereignty the euro area countries should give up in the areas of public finance and banking regulation in the interests of enhancing the economic stability of the euro area?

(5) whether the Polish accession to the euro area should remain a strategic goal of Polish and foreign economic policy? If so, how Poland should prepare for the entry into the euro area (apart from meeting the formal criteria of the EU Treaty) and what criteria to adopt for its final decision to adopt euro?

(6) whether Poland should actively seek the "domestication" ("polonisation") of banks operating in Poland, while respecting the EU's rules of antitrust policy and the single market? If so, how should this policy be implemented?