

Benoît Cœuré: The euro area sovereign debt market: lessons from the crisis

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the 12th IMF Annual Forum on Managing Sovereign Risk and Public Debt: “Managing Sovereign Debt: A Seismic Shift in demand and Supply Dynamics?”, Rio de Janeiro, 28–29 June 2012.

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Mr Deputy Managing Director, Ladies and Gentlemen,

It is a great pleasure to speak to you here today at the 12th IMF Forum on Managing Sovereign Risk and Public Debt. Clearly, this topic has never been more relevant than today.

In my remarks today, I will focus on the experience in the euro area and consider the following three questions: First, what has characterised the pricing of sovereign credit risk over the last two decades? Second, what is the relevance of the sovereign debt market tensions for monetary policy? And third, what lessons have we learnt?

What has characterised the pricing of sovereign credit risk over the last two decades?

Let me start with the first question, the pricing of sovereign risk. Looking at the sovereign debt markets of the euro area over the past two decades, it is possible to clearly distinguish three main periods. They all display distinct patterns of government bond pricing.¹

First, there was the run-up to Economic and Monetary Union (EMU), that is especially the period of about five years before 1999, when the euro was introduced. During this time, sovereign bond yields quickly converged towards those of German Bunds. Much of this convergence is explained by the elimination of exchange rate and inflation risks. In addition, European governments made great efforts to reduce their deficit and debt levels in order to fulfil the Maastricht criteria and join the common currency.

In the second period, ranging from the introduction of the euro in 1999 to the collapse of Lehman Brothers in September 2008, government bond yields remained at moderate levels and did not differ much from country to country. The yield spreads of ten-year government bond yields vis-à-vis German Bunds reached a maximum of about 70 basis points, and recorded about 15 basis points on average.²

These observations raise some questions: why did this period see such an undifferentiated pricing of government debt securities? And were the “macroeconomic fundamentals” characterising the different sovereign issuers similar? In fact, no: the state of public finances was distinctly and persistently different across countries. So why was the different degree of fiscal solidity (or rather the lack thereof) not “priced in” in government bond prices?

There are several reasons. Market participants may have been insufficiently forward-looking and too complacent. They may have extrapolated from their experience of a long period of

¹ See, e.g., European Central Bank, “Financial integration in Europe”, May 2011, Chapter I.2 for a characterization of different phases of bond market developments since the run-up to EMU and a more detailed overview of the bond market situation during the first stages of the sovereign debt crisis.

² This is based on ten-year government bond spreads of the initial twelve euro area Member States vis-à-vis Germany between January 1999 and August 2008, where Greek spreads are included as of 2001, when Greece joined EMU.

low macroeconomic volatility – the so-called “great moderation” – and may have felt insulated from any extreme macroeconomic event. In particular, it may have appeared inconceivable that any euro area sovereign issuer could actually reach its “fiscal limit” – that is, a situation where it could not re-finance its debt. Moreover, the “great moderation” experience led to low levels of investors’ risk aversion and low price of risk across asset classes. The depth of euro-denominated government bond markets, together with the expansion and diversification of global foreign exchange reserves, may also have created the false perception that the demand for sovereign bonds was infinitely elastic. Finally, the no-bail-out clause of the Maastricht Treaty may simply not have been fully credible for investors.

In the third phase, since autumn 2008, a sudden and disruptive re-pricing of sovereign credit risk has taken place. Government bond yields started to diverge, sometimes reaching levels that matched and exceeded those of the early 1990s. There were fundamental reasons for such a re-pricing of risk. Fiscal expansion due to the need to fight the crisis came on top of already high levels of public debt. Governments’ commitment to support systemically important financial institutions added to their contingent liabilities. Lower potential growth rates raised concerns for public finance sustainability.

In addition to these fundamental causes, sovereign bond markets in some jurisdictions have been characterised by poor liquidity and high volatility. In this context, investors’ worries regarding a loss of market access for some Member States may have become entrenched, and their expectations self-fulfilling. Moreover, for some countries, government debt market liquidity has been threatened to completely dry up in some periods. Overall, there has been a combination of fundamental causes and market distortions.

It soon became clear that the dramatic movements in government bond yields were not merely a barometer of investors’ valuation of liquidity and credit risk. Rather, the extreme levels of bond yields themselves were exerting an adverse influence on other financial market segments, the banking sector and also the effectiveness of monetary policy.

What is the relevance of sovereign debt market tensions for monetary policy?

There is a strong link between the stability of sovereign debt markets and the smooth functioning of monetary policy. This becomes very clear once we consider the prominent role of government bonds in the monetary policy transmission mechanism. I would like to identify four channels through which the functioning of government bond markets can interfere with the transmission of monetary policy. Let me call them the interest rate channel, the wealth channel, the collateral channel, and the bank balance sheet channel.

First, government bonds play a key role in transmitting the monetary policy stance to the real economy via the so-called interest rate channel. In times when government bonds are considered as essentially risk-free and liquid instruments, a change in current and expected policy rates is a central factor in shifting the government bond yield curve. Changes in long-term bond yields, in turn, translate to some extent into movements in corporate bond yields and bank lending rates – either via arbitrage relations or via pricing heuristics based on government bonds –, thus ensuring a smooth transmission of monetary policy throughout financial markets. However, since end-2008 bond yield changes of several sovereign issuers in the euro area have become heavily dominated by high and volatile premiums, often driven by contagion and market overreaction. Such effects have come to override changes in the monetary policy stance, blurring the transmission of monetary policy signals to the real economy.

Second, faced with threatening direct and indirect losses from strong price declines of sovereign bonds, consumers may opt for precautionary savings, which would counteract a desired stimulus to consumption from monetary policy easing.

Third, government debt securities have been a key source of collateral for banks to use in secured lending with other banks and the ECB. With the sharp decline in sovereign bond prices – often associated with a rating downgrade of the respective sovereign issuer – government bonds were made subject to significant haircuts and their refinancing power declined. This has eroded the volume of collateral available in the form of government bonds and stressed the re-financing possibilities of banks.

Fourth, the re-pricing of government debt also had a direct negative impact on the asset side of banks and therefore on their own perceived riskiness. In fact, since 2009, we can see a close relationship between measures of bank and sovereign credit risk. This sovereign-bank nexus constitutes a fundamental impediment to resolving the crisis in the euro area. On the one hand, rising sovereign credit risk affects banks' credit risk via their exposure to government debt. This creates deleveraging pressure that may turn into disorderly dynamics characterised by fire sales. On the other hand, ailing banking sectors increase the burdens faced by governments. These two effects are mutually reinforcing and constitute a vicious circle. For the banks, the increase in their own credit risk makes their re-financing harder. In short, unsecured financing is hampered by the perception of increased bank riskiness while secured financing is undermined by the erosion of collateral. This can in turn become a major obstacle to granting loans to the real economy. As banks are the main source of financing in the euro area, this could seriously jeopardise the flow of credit to enterprises and households.

What lessons have we learnt?

These developments in the euro area sovereign bonds markets offer one clear lesson: financial markets are prone to exaggerations, which amplify further the pro-cyclicality inherent in asset valuations. Usually, during “good times”, when risk appetite is strong and economic conditions are favourable, asset prices tend to be high and risk spreads tend to be low. However, financial markets tend to be over-complacent from time to time, especially after protracted periods that did not see any extreme events materialising. This tendency has probably led to an excessive tightening of euro-denominated yields in the run-up to the euro. In “bad times”, when the degree of risk aversion increases and GDP growth contracts, asset prices tend to decline and risk spreads rise. Also in bad times, this standard pattern of pro-cyclicality may be amplified by market exaggerations: investors tend to over-price certain types of risk and thus under-price the respective financial assets. Exaggerated pro-cyclicality of this type has hit the sovereign bond market during the crisis. Furthermore, in particular through the use of sovereign bonds as collateral, it has exerted adverse effects on other segments of financial markets, such as the funding markets for financial institutions.

To remedy exaggerated pro-cyclicality does not mean that we should dispense with the disciplining role of financial markets. The history of the monetary union teaches us an interesting lesson: when the disciplining role of intra-euro area exchange rates was lost, volatility and tensions have in fact migrated to sovereign debt markets, where they were building up under the surface. Even though markets sometimes misprice assets, they nevertheless provide a useful service in terms of signalling, price discovery and incentives. For example, if markets had not pushed up the yields of countries in weak fiscal positions, imbalances would have remained unnoticed and grown much larger, and the cost of fixing them would have been even higher. While attenuating exaggerated pro-cyclicality is important to avoid self-fulfilling expectations leading to bad equilibriums, at the same time we should recognise that markets have issued valuable signals.

There are a number of ways to mitigate exaggerated pro-cyclicality of government bond markets. One way is to reduce the reliance of the financial, regulatory and supervisory framework on credit ratings. The European Commission has put forward a number of proposals to this end. Similarly, it is worth considering ways to delink the risk assessment of credit institutions from the credit rating of the sovereign. In addition, risk management by

central clearing counterparties or CCPs is of particular importance, as an increasing number of financial transactions is expected to migrate to them. The CPSS-IOSCO principles for financial market infrastructures expect CCPs to adopt forward-looking and conservative margin and haircut policies to limit the risk of destabilizing responses to changes in credit ratings.

But to address the root causes of the current instability, fundamental policies will have to be adopted.

The adverse feedback loop between banks and sovereigns, that I mentioned before, can be broken by establishing a true financial union: in my view this includes the creation of a pan-euro area deposit insurance fund and a pan-euro area bank resolution framework, supported by a single supervisory system with centralised decision-making. If the European Stability Mechanism – an institution that can provide financial assistance to euro area Member States in order to safeguard the stability of the euro area as a whole – could inject capital directly into banks, this would also help to break the bank-sovereign loop. Of course, such support must come with strong conditionality and control. Let me note that depending on its design, the financial union could introduce additional elements of risk-sharing among euro area countries, and as such, it should be subject to strong democratic accountability and control at national and European level.

Most importantly, all euro area countries need to return to sound macroeconomic and fiscal positions. This may sound obvious, but unfortunately it has threatened to slip out of focus in some of the recent discussions.

There has been substantial progress towards consolidating the foundations of EMU. Fiscal rules are being strengthened, and almost all European governments have signed a Treaty that contains the so-called fiscal compact, which mandates all contracting parties to introduce legally enforceable debt brakes in their countries.³ The reformed governance framework also provides new tools to improve budgetary surveillance as well as to prevent and address macroeconomic imbalances – the “six-pack” reforms and the “two-pack” legislation are examples and should be forcefully implemented.

Looking ahead, a path towards a fiscal union, based on a principle of responsibility and with proper control and accountability, would provide a sound “fiscal pillar” on which the single currency could safely rest.

Some have suggested that it could provide a basis for the introduction of euro area-wide funding instruments with joint and several liabilities. Such instruments could contribute to a smooth functioning of a stability-oriented monetary policy, protecting Member States from temporary tensions arising in some parts of the Union and offsetting the emergence of self-fulfilling expectations leading to bad equilibriums. There is an important caveat, however. In his 1790 Report on Public Credit, Alexander Hamilton wished “to see incorporated, as a fundamental maxim in the system of public credit of the United States, that the creation of debt should always be accompanied with the means of its extinguishment”. Common funding instruments would require shared decision making on national debts and deficits and probably joint control on fiscal expenditures and taxation. They can only result from further political integration; they cannot precede it.

Likewise, and importantly, a fiscal union can only come about once the participating countries have successfully restored domestic fiscal sustainability and solidified the conditions for long-term growth. Joint debt issuance cannot be a substitute for putting national fiscal houses in order and restoring competitiveness.

³ “A fiscal compact for a stronger Economic and Monetary Union”, ECB Monthly Bulletin, May 2012.

Conclusion

Let me conclude. Euro area sovereign debt markets are going through unprecedented challenges. The inherent pro-cyclicality and the exaggerations that at times characterize financial markets should be recognized and addressed. However, structural problems call for structural answers. The current overhaul of fiscal, financial and economic governance in the euro area will help put the single currency on a sound and sustainable footing.