EUROPEAN SOVEREIGN DEBT MARKETS
- RECENT DEVELOPMENTS AND POLICY OPTIONS -

Note for the attention of the European Parliament's Special Committee on the Financial, Economic and Social Crisis (CRIS) for its meeting of 20 January 2011
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1. BACKGROUND

The outlook for the real economy in Europe is relatively favourable at the beginning of 2011. Most of the Member State economies have emerged from a sharp downturn linked to the economic and financial crisis and are growing again, although unemployment rates remain at elevated levels. As economic growth rates are still quite moderate, inflation pressure remains relatively subdued despite significant increases in the price of oil and other primary commodities. While the euro has weakened in nominal effective terms in recent months, it remains well above the most recent trough recorded in June 2010.

In contrast to the fairly positive evolution in the real economy, euro-area sovereign bond markets have experienced the severest tensions since the launch of Economic and Monetary Union in 1999. These tensions have been provoked by the budgetary impact of the economic and financial crisis, as reflected in sharply increased government deficits and debt for the majority of Member States. Government bond yields have increased rapidly in the peripheral Member States, resulting in the emergence of historical spreads relative to the benchmark German bund.

While bond yields in Greece and Ireland have reached a level that excludes these Member States from market-based funding, funding conditions for other Member States have also deteriorated substantially. Accordingly, the problems in euro-area sovereign bond markets are no longer confined to a small subset of Member States, but have become progressively systemic in nature. This note explores the factors underlying the emergence of the sovereign debt crisis (Section 2), describes the EU/euro-area policy response to date (Section 3), considers the addition policy steps required going forward (Section 4) and concludes by briefly examining the merits of possible joint issuance as a solution to the crisis.

2. EVOLUTION OF SOVEREIGN BOND MARKETS IN THE EURO AREA

The economic and financial crisis has its origins in the period of sustained low-inflationary growth from the late 1990s to mid-2007. This period was characterised by abundant liquidity in the global financial system, a generalised under-pricing of credit risk and the accumulation of massive risk exposures in banking systems. These credit risk exposures were inadequately managed and left the banking system vulnerable to the abrupt re-pricing of risk triggered by the emergence of losses on sub-prime mortgages in the United States. The ensuing banking crisis threatened a global financial meltdown and triggered a sharp contraction in the US and EU economies. In response, many governments were required to intervene in order to rescue their banking systems (implying a massive transfer of risk from the banking sector to the public finances) and to support economic activity (implying a substantial discretionary fiscal stimulus). The implications of this transfer of credit risk and expansionary fiscal policy stance for sovereign bond yields were initially masked by “flight to quality” effects among increasingly risk averse investors. However, as the crisis proceeded, financial markets have increasingly discounted the consequences of widening budget deficits and rising public debt levels for the sustainability of public finances in
sovereign bond yields. In this context, investors have become more discriminating as the economic and financial crisis has proceeded. Before the crisis, all euro-area government bonds were perceived by investors as effectively “risk-free” assets. However, investor concern about debt sustainability in some Member States has prompted a "flight to quality within a flight to quality" and a simultaneous decline in benchmark yields and increase in other more peripheral bond yields. Consequently, the convergence in sovereign bond yields in the euro area since 1999 has been abruptly reversed.

The divergence in euro-area sovereign yields intensified significantly in the course of 2010, due to concerns about wide budget deficits and rapidly rising public debt in some of the Member States. The spread between the yield on 10-year Greek government bonds relative to the benchmark (German Bund) reached 950 basis points at the end of 2010. At the same time, the corresponding spread for Irish bonds reached 600 basis points, 400 basis points for Portuguese bonds and 250 basis points for Spanish bonds. The evolution in sovereign Credit Default Swaps (CDS) spreads (often considered as a purer measure of credit risk) paints a similar picture to that of yield spreads. Credit rating agencies responded to the deteriorating budgetary conditions by substantially downgrading the sovereign debt of Greece, Ireland, Portugal and Spain.

By end-2010, both Greece and Ireland were unable to obtain market funding at sustainable interest rates and had negotiated external financial assistance under EU-IMF programmes. Moreover, tensions in the euro-area sovereign bond markets had intensified and become more widespread, extending beyond the peripheral Member States. Some easing of tensions was provided by the decision of the European Central Bank (ECB) to extend its purchases of government debt securities as required by market conditions. At the end of 2010 the overall amount of euro-area government bonds purchased under the ECB’s Securities Market Programme reached about EUR 70 billion.
The crisis-induced deterioration in budgetary performance among euro-area Member States resulted in the supply of government bonds reaching a record high of about EUR 1,300 billion in 2010. Despite a budgetary tightening in the course year, the supply of government bonds scheduled to mature in 2011 is even larger. Based on available data, it is estimated that about EUR 1,450 billion of sovereign debt securities will mature in 2011 in the EU Member States, of which EUR 1,241 billion will be in the euro area and EUR 217 billion elsewhere in the EU.

A very substantial portion of euro-area sovereign debt is scheduled to mature in the first quarter of the year; about EUR 485 billion (40% of the total) will mature before the end of March. Portugal, Spain and high debt economies, such as Belgium and Italy, must cover more than a third of the total EA refinancing needs (EUR 169 bn). Total gross sovereign financing needs are likely to be even higher, as budget balances remain negative in most euro area Member States.

Against this background, serious tensions remain in euro-area sovereign bond markets, as investors continue to focus on the sustainability of public debt in the Member States. These tensions are likely to translate into wider economic consequences. Higher priced sovereign issuance can lead to a crowding out of private-sector financing and further weaken economic activity. The austerity measures introduced by governments, albeit necessary, have also side-effects as they consist of expenditure cuts and tax rises, which impact negatively internal demand and general economic activity leading further to lower economic growth.

3. POLICY RESPONSES TO SOVEREIGN DEBT MARKET TENSIONS

A series of policy measures have been taken in response to the tensions in euro-area sovereign debt markets. In general, Member States have reiterated, and where appropriate, reinforced their commitment to budgetary consolidation in line with the targets agreed under the Stability and Growth Pact. More specifically, the following measures can be highlighted:

- Financial assistance to Greece: On 2 May 2010, the Eurogroup agreed to provide stability support to Greece via bilateral loans for a total amount of EUR 80 billion. Euro-area financial assistance is part of a joint package with the IMF, totalling EUR 110 billion. The assistance package fully covers government financing needs related to the deficit and maturing medium- and long-term securities until end-2011. Greece is expected to gradually return to markets for long-term funding in the course of 2012.
- Establishment of the EFSM and EFSF: On 8 May 2010, the ECOFIN Council decided to establish a European financial stabilisation mechanism (EFSM), based on Art. 122.2 TEU with a volume of up to EUR 60 billion. In addition, based on an intergovernmental agreement of euro area Member States, the European Financial Stability Facility (EFSF) was created. The EFSF is guaranteed on a pro rata basis by participating Member States and has a nominal funding capacity up to EUR 440 billion. The activation of the EFSM or the EFSF is subject to strong conditionality, in the context of a joint EU/IMF macroeconomic adjustment programme. Loans provided via the EFSM and EFSF are on terms and conditions similar to those of IMF loan. The EU (as issuer for the EFSM) and the EFSF are rated AAA by the three major credit rating agencies, Fitch, Moody's and Standard & Poor's. Both the EFSM and EFSF are temporary facilities, with the EFSM subject to six-monthly review while lending by the EFSF will end by mid-2013.

- Financial assistance to Ireland: On 28 November 2010, the Eurogroup and the ECOFIN Council decided to grant stability support to Ireland via the EFSM and EFSF. The financial package will cover financing needs up to EUR 85 billion. The EU will provide up to EUR 22.5 billion and the EFSF up to EUR 17.7 billion over 2011 and 2012. The IMF will provide up to EUR billion 27.3 and up to EUR 17.5 billion will be provided by the Irish government.

- Finally, the December European Council agreed on the text of the draft decision amending the TFEU, in order to establish the future European Stability Mechanism (ESM). The ESM will be a permanent mechanism and will replace the EFSF from mid-2013. The Eurogroup and the Commission have been mandated to finalise work on the intergovernmental arrangement, allowing the European Council to reach agreement in March 2011. The ESM will complement the new framework of reinforced economic governance, aiming at an effective and rigorous economic surveillance, which will focus on prevention and will substantially reduce the probability of a crisis arising in the future. An important element of the ESM will be the possibility, on a case by case basis, of participation of private sector creditors, fully consistent with IMF policies.

4. Need for more comprehensive response

The policy measures taken over the past year were necessary and have had an important impact on markets. Nevertheless, bond markets in the euro area remain very tense and the arrangements put in place in the course of 2010 have been overtaken by events. With the expected supply of sovereign bonds in the euro area very high and continued risk aversion among many investors, there is a need for a more comprehensive and coherent policy response to address investor concerns.

The main concerns of investors relate to the sustainability of public debt in Member States, the solvency and liquidity of the EU banking sector and perceived shortcomings in the EU and euro-area economic governance. Hence, a comprehensive and effective strategy must address all these concerns. Such a strategy will require ambitious measures in a wide range of policy fields. Budgetary consolidation efforts must be intensified. Growth-enhancing structural reforms must be implemented immediately. The arrangements for external financial assistance (notably the EFSF) must be made more effective. EU banks must undergo a new and more rigorous stress test. And, the proposals to reform economic governance must be implemented without further dilution. Moreover, all of these measures must be agreed and implemented as rapidly as possible. The Commission's Annual Growth
Strategy, which was adopted on 12 January, is a first contribution to this more comprehensive response to the crisis. The AGS identifies a set of critical measures to stimulate growth, via growth-enhancing structural reforms. If fully implemented, this strategy will help the EU come out stronger from the crisis and turn the EU into a smart, sustainable and inclusive economy delivering high levels of employment, productivity, competitiveness and social cohesion.

5. COMMON ISSUANCE OF SOVEREIGN BONDS IN THE EURO AREA

The idea of common issuance has been discussed since the launch of EMU\(^1\), mainly as a means to further integrate EU financial markets and create a large and liquid sovereign bond market to rival the US Treasury and Japanese government bond markets. However, the tensions in euro-area sovereign bond markets have focused attention on the possibility of common issuance of sovereign bonds in the euro area as a possible element of the comprehensive policy response.

The most recent proposals for common issuance suggest that government bonds issued by Member States would be split into two different seniority types (junior/senior). The more senior bonds would be pooled into a common bond, while the junior bonds would be issued as national bonds. Most proposals specify particular percentages of GDP for the distribution of total issuance between these two different seniority levels. In order to accelerate the process of creating a large common bond market, it has also been proposed to exchange common bonds for national bonds on the secondary markets.

Common issuance could improve the attractiveness and functioning of euro-area sovereign bond markets and would drive further financial integration in Europe. The seniority and liquidity of the common issuance would be reflected in low risk premia, although the implications for risk premia on the junior national issuance are uncertain. The precise design of common issuance would decide how the credit risk premium would be distributed the two types of issuance, but the credit risk premia would typically be higher for junior national bonds. However, these concepts have so far not been studied in detail or quantified. While common issuance is intellectually attractive, a number of technical and legal obstacles would need to be overcome. Accordingly, the economic merits and political acceptability of common issuance require further reflection. In the meantime, the EU and euro area policymakers will focus on the existing instruments – EFSM, EFSF and future ESM – so as to maximise their effectiveness in addressing the crisis.

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\(^1\) As early as in 2000 the Giovannini group raised the idea of joint issuance. In 2008 the Commission discussed joint issuance/E-bonds already in its publication EMU@10. Also in 2008 the European Primary Dealers Association (EPDA) published a discussion paper on this subject. More recently, the concept of joint issuance/E-bond was part of the Monti report. Concrete proposals of an E-Bond have been put forward by Bruegel in May 2010 (The blue bond proposal) and by Messrs. Juncker and Tremonti in an FT article in December 2010.