Meeting Report

Speakers:

- *Peter Grasmann*, Head of Unit, Economic Analysis of Financial Markets and Financial Stability, European Commission
- *Steven Major*, Global Head, Fixed Income Research, HSBC
- *Nikolaos Panigirtzoglou*, European Head, Global Asset Allocation and Alternative Investments, JP Morgan
- *Daniel Gros*, Director, CEPS
- *Wim Boonstra*, Chief Economist, Rabobank Group [moderator]

- **Has the sovereign debt crisis stabilised in 2012?**
  The governance mechanisms adopted, the agreement on the second Greek rescue package, and the expectation that member states will reinforce firewalls, have all contributed to a compression in yields in the first months of 2012. Yet, probably the crucial trigger has been the intervention of the ECB by providing longer-term liquidity to banks (the so-called longer-term refinancing operations or LTROs).

- **How do bond markets see the policy measures taken so far?**
  In the way of an equation, bond markets see that LTRO + ESM – PSI = LY, meaning the combination of these three policies leads to low yields. On the one hand, the longer term refinancing operations (LTROs) and the European Stability Mechanism (ESM) help re-establish market confidence. Panellists highlighted that the ESM is viewed as the first step towards the mutualisation of national debt and common issuance. On the other hand, private sector involvement (PSI) is adversely perceived by market participants and has arguably led to contagion. Some of the panellists discarded PSI outright while others acknowledged that involving the private sector is justified to reduce moral hazard and distribute the costs of the crisis. Yet, the latter observed that the size of the PSI in the Greek bailout (estimated at EUR 65bn) is small compared to the costs in terms of lower growth and contagion that have resulted from the loss in market confidence. Market participants would like to see clear actions that would completely discard the use PSI mechanisms in the future and are not satisfied by the promises made by leaders in the euro-area. Markets demand also decided action towards growth in Europe.

- **But isn't private sector involvement a reality-check?**
  One of the panellists considered the PSI as just a reality check that proves that sovereign debt is no risk free. Low growth, no sovereignty on monetary policies, shrinking working population and high debt to GDP ratios are non-negligible aspects and should have been considered by market participants before the sovereign bet crisis materialised. While markets would not like to see PSI, some players are in fact expecting some sort of PSI in Ireland and Portugal, based on the macro and fiscal fundamentals of these economies.

- **What is the market view about collective action clauses?**
  Collective action clauses (CACs) are typically incorporated into the debt instruments issued by developing nations. Inserting these clauses in the debt of developed countries would be pernicious, according to some market participants. For instance, it would deter the participation of institutional investors in sovereign debt instruments with long maturities. Market participants believe that there is a need for risk-free assets (to protect the 'sanctity of contracts') as a benchmark to value other assets but also as a reserve of value. While investors may choose to access the high-yield market, they should also be able to access risk-free assets. Against this argument, some panellists pointed out that, while sovereign debt may appear to be risk free, practice central banks may generate inflation that would erode the value of the debt in way similar to a partial default following collective action.

- **What role for prudential regulation?**
  In the future, prudential regulation for banks and other intermediaries should recognise that sovereign debt is not risk-free and allocate capital weights accordingly. One of the panellists proposed in particular to revise CRD IV to reverse the zero-risk weight for sovereigns —but introduce grand-fathering to smooth the transition given the current stress in sovereign debt markets. Similarly, the Large Exposures Directive could be modified to limit the exposure of banks to a single sovereign issuer so as to avoid the repetition of sovereign-bank feedback loops in Europe.

- **Do CDS contracts provide meaningful protection?**
  Authorities are so far relying on the industry body ISDA to qualify the events that would trigger the payment of compensation in CDS contracts, of particular importance in the PSI programme for Greece. These contracts insure the risk of default and are generally viewed as a useful instrument that complements the risk management function of participants in sovereign debt markets. A panellist considered however that ISDA suffers inherent conflicts of interests that may have to be addressed by regulators and supervisors. If CDSs are not triggered when investors expect or the conditions are so loosely framed that their triggering becomes discretional, markets will stop using these contracts.

- **What is the impact of LTRO on banks and the real economy?**
  The LTROs carried-out by the ECB in 2011 and 2012 will help banks overcome the deterioration of financing conditions in markets over the next few years. Yet, there are uncertainties about hidden effects that would become apparent at the end of the LTRO horizon. One of the persons in the audience was wary that banks in the North of Europe could unload Southern sovereign debt onto local banks, further destabilising the peripheral countries when the LTROs mature. In this regard, it was felt that the effects of LTROs should be closely monitored and authorities should build now an exit strategy. The impact on the real economy of LTROs will depend on whether banks increase their lending. One of the panellists pointed at evidence still suggesting that banks have so far not increased their lending substantially and have instead partially used the ECB facility to substitute commercial sources of funding. Panellists from financial institutions argue that they would rather the ECB and national central banks do not discard the possibility of a third LTRO ex-ante.

- **How to start building a common bond issuance?**
  Market participants and commentators are largely in favour of adopting common issuance in the euro-area. There is some consensus that short-term paper would provide the best starting point (a euro T-Bill market). One of the panellists explained that relatively better-off member states have difficulties accepting common issuance, not so much because of the possible increase in yields (from moderate to small) but because of the mutual guarantees that would be required. To overcome this initial reticence, another panellist proposed to introduced common issuance selectively and on a temporary basis, which if proved successful would likely become permanent and general. Arguably, common issuance is likely to arrive before fiscal union in Europe.

- **Are euro-area governments profligate?**
  Panellists observed that the levels of debt and deficit in Europe are smaller than in comparable economies such as the US or Japan, which would not justify the difference in spreads present today in markets. In effect, classical fiscal theory would not censor the behaviour of most European governments. Yet, financing conditions in markets are such that they impose fiscal consolidation in Europe.

- **Does the euro-area need overseas lender now?**
  Foreign lenders have largely retracted from the euro-area. While political leaders strive to regain the trust lost among foreign investors, one of the panellists argued that capital outflows would make adjustment more difficult in member states such as Italy or Spain. A weak euro may be essential for the recovery, facilitating exports and ultimately economic growth. The same panellist considered that the euro-area has enough savings to finance its own sovereign debt but a lack of confidence in southern economies stops liquidity from moving down the Alps. The adjustment would however need time.

- **How to achieve a balance of payments turnaround**?
  For countries such as Italy of Spain a balance of payments turnaround may be achieved in the medium term both by reducing internal consumption and increasing exports, under propitious exchange rate conditions. For other countries such as Greece and Portugal, one of the panellists was afraid that a larger contraction of internal consumption would have to take place. Some commentators fear that these latter countries would have to experience a decrease in GDP in the order of 20% before recovering, as for Baltic countries.

More information

- Please visit www.eurocapitalmarkets.org/sovereignflux
- Or contact Mirzha de Manuel at mirzha.demanuel@ceps.eu

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Note: Parts of this research seminar will held under the Chatham House Rule.

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