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Looking beyond the Euro Area Sovereign Debt Crisis

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Three years into the euro area sovereign debt crisis, investors continue to shun periphery government bonds, European banks are under severe funding pressures in both the dollar and euro private term markets, and the euro area is facing an anemic growth outlook. On the face of it, the scenario portends gloom. But upon closer examination of the inner workings of the European Union (EU) governance system, the ongoing adjustment in the banking sector, and the rewiring of the landscape of euro sovereign debt markets, the future scenario looks more balanced, particularly following the conclusion of the protracted negotiations on Greek bond exchanges under an EU-backed voluntary private sector involvement (PSI) scheme. As euro area leaders formulate significant structural reforms to deal with the continent's longstanding fiscal and governance shortcomings, this note argues that striking a balance between market discipline and centralized rule-making is the best way forward.

The euro area sovereign debt crisis currently playing out has forced the international policy community to come to grips with the changing nature of sovereign risk in advanced economies. In addition to the straightforward elevated risk levels brought about by the financial crisis and the Great Recession of 2008–9, other long-term structural factors are reshaping the sovereign risk environment in advanced economies—namely, rising health care and pension costs in the face of aging populations and a broadening global investor base that now includes the private sector, the public sector, and financial institutions in domestic and foreign markets.

Coping with higher levels of sovereign credit risk in advanced countries with international currency status (whose debt traditionally has been considered free of credit risk) will require fundamental changes in market practice and policy. Investors will need to revise their analytical processes to factor in the possibility that a sovereign could fail to service its debt obligations in time and in full. Policy makers, for their part, must

develop a clear game plan and resolution mechanism outlining how to respond to a repayment crisis once it has begun. Both of these elements have been missing thus far in the euro area sovereign debt space, leading to a dramatic increase in investor uncertainty and, in turn, high market volatility and dramatically widening spreads on the debt of the most troubled countries. The yield spread on 10-year government Irish bonds relative to German bunds stood at 567 basis points (bps) as of end-January 2012, compared to 24 bps in 2000, a year after the launch of the euro. Greek bonds are now trading at 24 cents to the dollar, and Portuguese bonds at 56 cents to the dollar.

Euro area economies have paid a heavy price for having their public finances increasingly scrutinized by global investors. It makes eminent sense now to delegate part of the responsibility for monitoring and sanctioning of individual member states' public sector finances to the market place. As investors focus on euro area sovereign debt, with a mind toward credit quality at the national level and reinvigorated fiscal capacity at

the union level, market discipline can be viewed as a force in creating a more sustainable euro area public debt market, embedding a redefined concept of sovereign and bank risk, with private creditors sharing the consequences of debt distress. Over the long term, achieving fiscal sustainability will expand the capacity for euro-denominated sovereign debt to serve as the second pillar of global capital markets, alongside U.S. treasuries. This note argues that both the institutional and market failure aspects of the crisis need to be addressed to restore confidence and bring about an orderly solution.

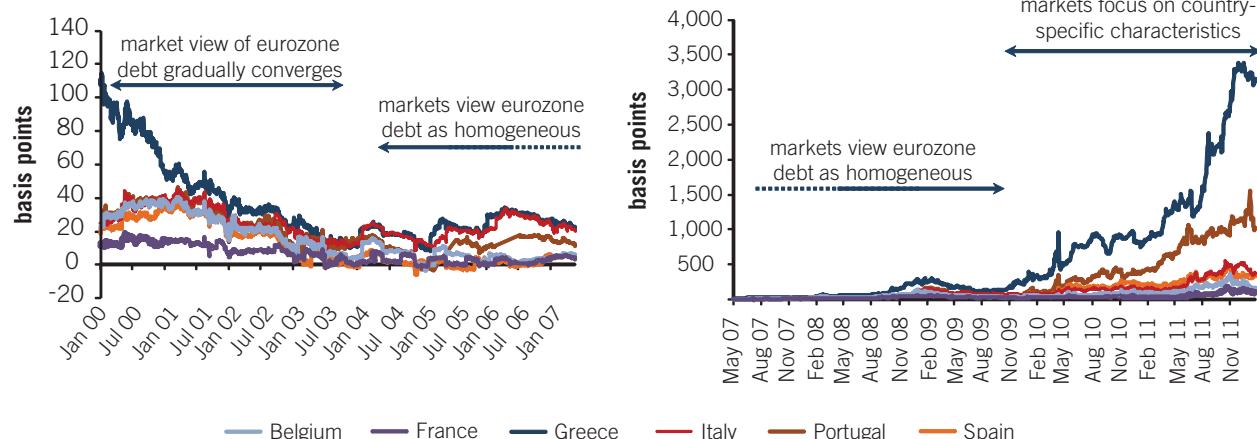
Rewiring the Landscape of Euro Sovereign Debt Markets

Driven by elimination of intra–euro area exchange rate risk following the introduction of the euro, the common monetary policy blanket provided by the European Monetary Union (EMU) and market harmonization, yield spreads narrowed considerably across euro area countries in the years prior to the financial crisis, reaching as low as 20 bps in early 2007 (figure 1). Euro area countries attracted growing investment flows during the first decade of the euro, particularly from official investors (such as central banks) seeking a legitimate alternative to the U.S. dollar for their foreign reserve holdings. As of end-2010, the world had invested €15.17 trillion of its wealth in euro-denominated assets, close to 40 percent of the aggregate gross domestic product (GDP) of the rest of the world. Data from the Bank of International Settlements (BIS) confirm the importance of the euro in global foreign exchange markets: in 2010, turnover of euros in global foreign exchange markets averaged \$1.11 trillion per day, compared to the U.S. dollar's turnover of \$3.37 trillion. The ability of euro area member states to issue debt internationally in their common currency

affords them the important benefit of drawing on the European Central Bank's balance sheet to stabilize bond markets through large-scale purchases of government debt at times of extreme market distress, providing a degree of structural stability to sovereign markets.

Despite the many advantages that the international status of the euro has conferred on euro area borrowers on the global stage, those advantages have not saved the euro area from an intensifying and increasingly contagious sovereign debt crisis over the past two years. Though the manner in which a sovereign debt crisis unfolds differs from case to case, the basic dynamics always involve a shift in the relative importance of three key drivers of the market: fundamentals, risk appetite, and prospects for the balance of demand and supply. In normal times, fundamentals and technical demand and supply factors dominate investor sentiment and trading practices. But at times when investors lose confidence in the ability of a sovereign to fund its new and maturing debt in an orderly fashion, risk aversion becomes paramount in driving markets, expanding the imbalance between demand and supply. Thus, supply of sovereign debt tends to increase due to the shortening of debt maturities, translating into higher rollover requirements and—due to higher interest rates the sovereign must pay on new bonds—higher debt-servicing costs. On the demand side, as the riskiness of holding the sovereign's debt increases (typically confirmed by slashing of the country's sovereign credit rating by major agencies), nervous investors rush to reduce their exposure and liquidate their existing holdings of the sovereign's bonds. At this stage, a country's gross funding requirements—redemption, interest payments, and the primary deficit—are significantly larger than in normal times. The ability to roll over maturing debt, something that occurs almost automatically

Figure 1. Euro Area Sovereign Bond Spreads over the Benchmark German Bunds



Sources: Based on data from Bloomberg.

Note: Factor analysis of 10-year sovereign bond spreads over German bunds for seven euro area countries (Greece, Portugal, Spain, Italy, France, Belgium, and the Netherlands) shows that between 2006 and 2008, the first factor alone explains 99 percent of the common variation. For the period starting in 2009, the first factor explains 85 percent of the common variation, and a second factor is needed to account for an additional 14 percent.

during normal times, becomes a major challenge, and the amount of financing needed by the sovereign is much larger than what private markets are willing to absorb.

Preliminary econometric investigation of the determinants of five-year credit default swap (CDS) sovereign bond spreads for core and periphery euro area countries reveals the significance of volatility and “flight-to-quality” trade indicators, confirming the view that the crisis has been driven by extreme investor anxiety and panic (table 1). The macroeconomic collateral damage of heightened sovereign risk is likely to be large. By virtue of the fact that corporate bonds are typically priced based on the existing sovereign yield curve, and that sovereign debt bears primarily macroeconomic risks, there exists a structural link between sovereign and corporate bonds, reinforced in times of crisis by deteriorating macroeconomic conditions. In previous work, Dailami (2010) examines the dynamics of sovereign debt crises and their channels of transmission to the corporate side, showing that episodes of intense fiscal and sovereign debt pressure in emerging-market economies were associated with a significant widening of their corporate bond spreads.

Developing a Credible Approach for Crisis Prevention and Resolution

Throughout the post–World War II era, successful resolution of sovereign debt crises has typically involved three main elements: a clear game plan to frame the overall process, an official

third-party agent to formulate the necessary macroeconomic adjustment within a credible debt sustainability framework, and availability of large rescue and concessionary financing. Sovereign debt crises of major emerging economies in the 1990s and early 2000s followed this pattern because they were characterized by the Westphalian conception of sovereignty among modern nation-states and membership in the Bretton Woods financial institutions, had direct involvement by the International Monetary Fund (IMF) and the World Bank as the third-party agents, and included rescue packages of several multiples of affected countries’ IMF quotas (table 2). Furthermore, the fact that much of the emerging-market sovereign debt in question in these crises was issued under New York and/or U.K. governing law helped to facilitate crisis settlements and debt workouts, because creditors could appeal to a well-established body of law to protect their rights, even if their efforts to promote an orderly resolution among creditors turned out to be controversial and culminated in the adoption of the market-based approach of collective action clauses (CACs), which contained provisions permitting a majority of holders of a given country’s sovereign bonds to agree to a restructuring that would bind all other bondholders.

The most conspicuous difference between today’s euro area sovereign debt crisis and the emerging markets’ crises of the 1990s is the ambiguity faced by today’s bondholders with respect to the procedures and rules of crisis management when a euro area member state loses access to private markets. The

Table 1. Determinants of Five-Year Sovereign CDS Spreads in Selected Euro Area Countries (January 1, 2009 – January 13, 2012)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
CDS spreads	Germany	France	Austria	Belgium	Greece	Ireland	Portugal	Spain	Italy
VIX	1.006 (12.73)***	1.941 (11.80)***	0.170 (0.94)	2.925 (9.97)***	8.348 (3.22)***	3.117 (3.21)***	5.846 (10.55)***	4.931 (13.93)***	6.261 (15.89)***
S&P 500	0.118 (37.12)***	0.336 (51.04)***	0.033 (4.62)***	0.551 (51.37)***	0.992 (5.95)***	-0.035 (0.41)	0.759 (19.07)***	0.537 (19.33)***	0.675 (40.04)***
Euribor-OIS spread	0.663 (32.82)***	1.449 (34.56)***	1.568 (34.02)***	2.139 (25.92)***	3.181 (3.88)***	-0.927 (3.31)***	0.256 (1.56)	0.271 (1.95)*	2.150 (15.59)***
Euro/USD\$	-69.337 (13.47)***	-167.103 (15.79)***	-106.371 (9.14)***	-237.400 (13.42)***	-458.817 (3.56)***	-417.224 (7.21)***	-671.346 (19.87)***	-510.981 (21.87)***	-260.907 (10.58)***
Sovereign risk ^a	(dropped)	(dropped)	(dropped)	-1.208 (0.28)	114.147 (32.71)***	63.738 (24.10)***	83.375 (57.34)***	38.549 (12.58)***	40.583 (14.02)***
Constant	-44.863 (5.08)***	-182.449 (9.99)***	132.234 (6.58)***	-331.887 (10.50)***	-1,029.357 (3.61)***	735.656 (4.56)***	-68.055 (0.85)	132.214 (2.41)**	-556.279 (13.11)***
Observations	778	780	789	784	704	761	788	788	791
R-squared	0.85	0.88	0.80	0.86	0.88	0.86	0.97	0.87	0.88

Source: Author’s compilation from Bloomberg.

Note: * significant at 10% level; ** significant at 5% level; *** significant at 1% level. Absolute value of t-statistics in parentheses. The above analysis provides ordinary least square estimations of determinants of 5-year sovereign CDS spreads for both core and periphery eurozone countries, as a function of sovereign ratings, volatility indicators, flight to quality, and funding conditions, using daily observations from January 1, 2009, to January 13, 2012. The estimated coefficients here are mostly significant, confirming the panic-driven dynamics of sovereign debt spent over this period. VIX = Chicago Board Options Exchange Market Volatility Index; Euribor-OIS spread measures bank funding conditions in euro interbank markets and is defined as the difference between EURIBOR (interbank rate) and OIS (overnight rate swap index).

a. A better rating is associated with lower sovereign risk. Country ratings were sourced from Moody’s.

Table 2. International Financial Rescue Packages for Emerging-Market Sovereigns in Distress

Country/date	Rescue package, US\$ billions	Multiple of IMF quota	Current account deficit, US\$ billions (% of GDP)	Total foreign debt, US\$ billions	Short-term foreign debt, US\$ billions	External financing gap, ^a US\$ billions
Mexico (Feb 1995)	53	20	29.7 (7)	139	39	64
Thailand (Aug 1997)	17.2	22	14.7 (8.1)	113	48	63
Indonesia (Nov 1997)	37	27	7.7 (3.4)	129	32	47
Korea, Rep. of (Dec 1997)	60	56	23.2 (4.2)	125	76	98
Brazil (Nov 1998)	41	14	33.8 (4)	241	30	69
Turkey (Dec 2000)	22.5	18	0.9 (0.4)	102	23	36

Source: Author's compilation from various sources, including, World Development Indicators, and Economist Intelligence Unit.

a. Defined as external financing needs (current account deficit plus short-term debt and principal repayments on medium- and long-term debt) minus net equity flows.

fundamental approach to sovereign debt prevention and management envisaged in the EMU architecture drew on a combination of rule-based provisions in the Lisbon Treaty and expected market reaction to excessive debt accumulation at the national level. With fiscal authority among EU countries retained at the national level under the principle of subsidiarity, promotion and enforcement of fiscal discipline at the EU level was intended to be achieved through compliance with article 125, which states that "the Union shall not be liable for or assume the commitments of central governments, regional, local, or other public authorities, other bodies governed by public law, or public undertakings of any Member State" (informally known as the "no-bail-out clause"), and with article 126, which states that "Member States shall avoid excessive government deficits."

A question of much interest is how well market participants have been able to comprehend the complex EU fiscal governance system in pricing the sovereign debt of individual member states. The significant convergence of sovereign bond yield spreads during the run-up to the launch of the euro and the continuation of that trend virtually until the outbreak of the crisis, in conjunction with the observation that markets failed to detect and signal the deterioration of Greek public finances until the second half of 2010, suggest a degree of myopia and market failure. Investors seemed to have taken a benign view of individual member states' sovereign credit risk profiles, either because they believed that in the unlikely event of a euro area sovereign facing distress, other EU member countries would step in to assist, or because of the monetary credibility associated with the independence of the European Central Bank (ECB). The extent of intra-EU involvement in currently distressed countries remains an open question.

For private sector bondholders accustomed to the notion of euro area sovereign debt as a risk-free asset class, the likelihood that they may need to take potential portfolio losses due to maturity extensions, interest rate cuts, and/or net present value (NPV) haircuts has been difficult to swallow, even though

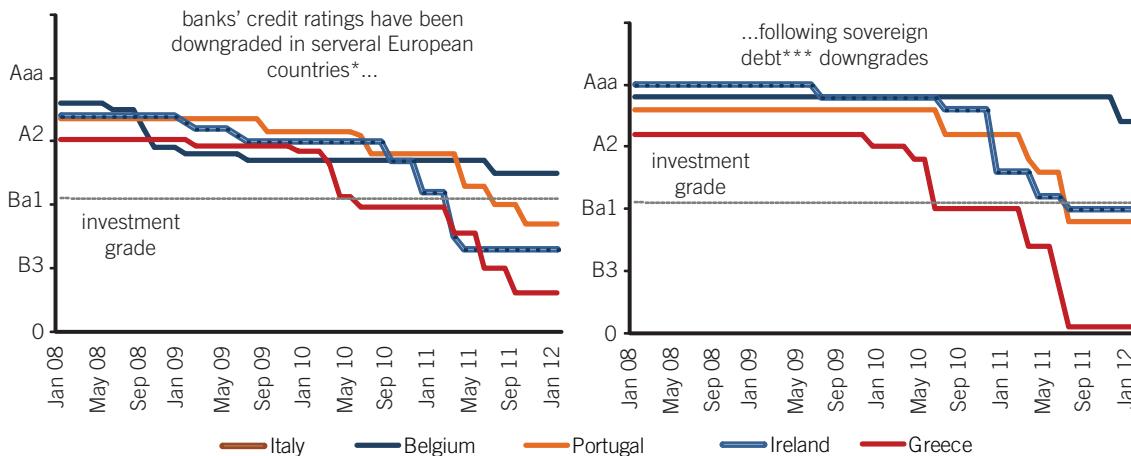
the prevailing narrative has stressed the voluntary nature of restructuring private sector-held debt, and within that has restricted restructuring to Greek sovereign debt. Signaling the new era of private sector burden sharing in the event of a euro area sovereign need for debt restructuring, a November 28, 2010, statement by Eurogroup finance ministers and the Economic and Financial Affairs Council (ECOFIN) provided the EU-wide backing for sovereign debt restructuring. The Eurogroup stated that "in the unexpected event that a country would appear to be insolvent, the Member State has to negotiate a comprehensive restructuring plan with its private sector creditors, in line with the IMF practices with a view to restoring debt sustainability." To facilitate potential debt restructuring, the Eurogroup will include standardized CACs in all new euro area government bonds starting in June 2013.

Strengthening Bank Capital and Improving Resolution Regimes

One key action that would move the euro area beyond its sovereign debt crisis would be to shore up the balance sheets of European banks that have large exposures to troubled sovereign debt, recognizing that a heightened level of sovereign risk has strong negative implications for the stability of the financial sector as a whole. Measures introduced thus far by European leaders to contain the negative consequences arising from the sovereign side on bank funding and capital positions have focused on transparency, recapitalization, liquidity provision, and changes in bank resolution regimes (that is, bail-ins).

Within the corporate universe, banks are more susceptible than other types of firms to sovereign stress, as they are characteristically more levered than nonfinancial firms and rely on government securities to carry out a variety of activities: securing wholesale funding, conducting derivatives business, maintaining regulatory and liquidity standards, and diversifying asset portfolios. These links with the government are why banks' credit rating downgrades have closely followed those of sovereigns over the course of the crisis (figure 2).

Figure 2. European Sovereign and Bank Credit Rating Changes, January 2008 – January 2012



Source: Based on data from Bloomberg.

- a. Moody's ratings of 31 European banks' various types of debt.
- b. Moody's sovereign debt ratings.

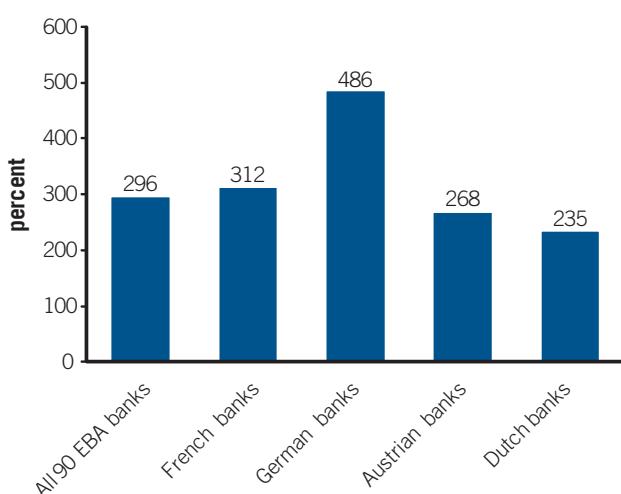
As a step toward enhancing transparency and therefore banks' asset quality, the European Banking Authority (EBA) has released detailed data on individual banks' holdings of sovereign debt, disaggregated by home and sovereign counterparties, as part of its latest round of stress tests of European banks. Covering 90 major banks in 15 EU member countries with total assets valued at €27.47 trillion (79 percent of aggregate EU banking system assets) as of end-2010, the figures provide a unique window into the extent and nature of bank exposures to sovereign debt. One initial finding is that banks' sovereign risk exposure, as measured by banks' direct holdings of sovereign debt, varies considerably. Collectively, banks included in the sample held €2.97 trillion of sovereign debt (10.8 percent

of their assets) as of end-2010, of which €1.73 trillion was debt issued by euro area sovereign borrowers.

An alternative—and in many cases more informative—assessment method of banks' sovereign debt exposure is to measure direct exposure to sovereign debt in relation to core tier 1 capital, against which potential losses would have to be written down. By this measure, the 90 European banks in the EBA sample held, on average, sovereign debt worth 296 percent of their core tier 1 capital, though the amount varies substantially according to banks' home country (figure 3). Banks' exposure to the euro area sovereign risk as a whole is estimated to be 172 percent of their core tier 1 capital. Figure 4 distinguishes between banks' exposure to home and foreign sovereigns. Austrian, Belgian, British, Dutch, Danish, and French banks hold, as a proportion of their tier 1 capital, a large amount of foreign sovereign debt, reflecting the internationally active nature of their business models. In contrast, banks located in Greece, Ireland, Italy, and Spain have a high concentration of home sovereign securities. Germany and Luxembourg hold home and foreign sovereign debt in roughly equal proportions of their tier 1 capital. And as the analysis contained in table 3 shows, banks with a high exposure to the sovereign debt of Greece, Ireland, and Portugal have experienced a much sharper credit downgrade.

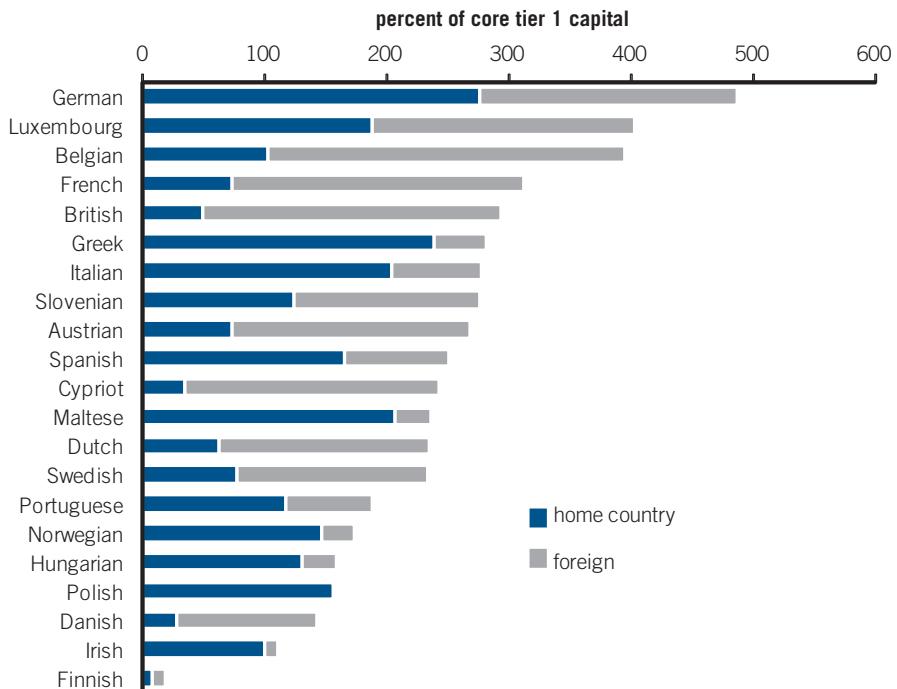
Alarmed by increasing signs of funding vulnerabilities within the euro area banking system in the second half of 2011, authorities formulated a range of financial and regulatory responses intended to strengthen the banking system, including through recapitalization, a key pillar of the road map announced by the president of European Commission on December 10, 2011. To that end, major European banks will be required, according to a proposal by the EBA, to strengthen their capital positions through additional capital buffers to

Figure 3. European Banks' Exposure to Sovereign Debt as a Percentage of Their Core Tier 1 Capital



Source: Based on data from European Banking Authority : 2011 EU- Wide Stress Test Results.

Figure 4. European Banks' Exposure to Home Country and Foreign Sovereign Debt



Source: Based on data from European banking Authority : 2011 EU-wide Stress Test Results.

achieve a level of core tier 1 capital of 9 percent of their risk-weighted assets by end-June 2012.

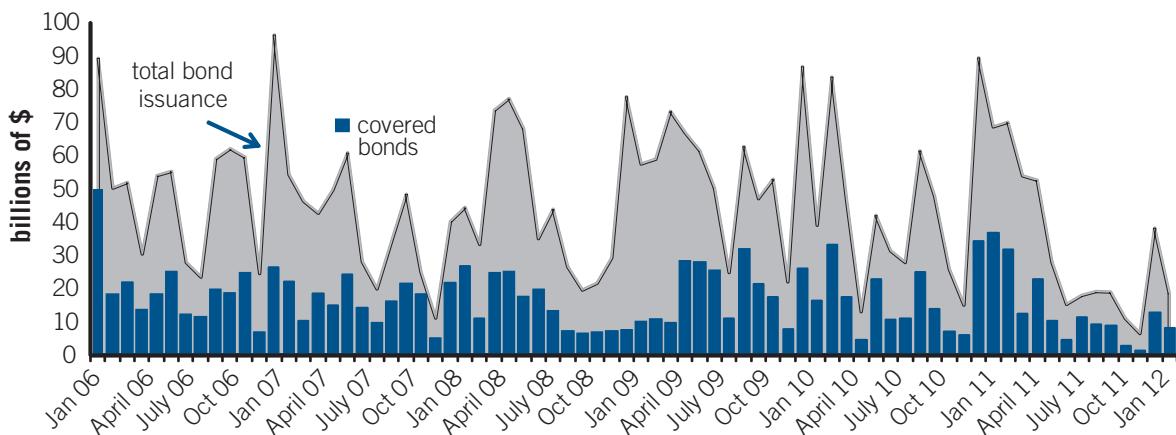
It remains to be seen to what extent this new recapitalization plan will fulfill its intended objective of restoring stability and confidence and to what extent it serves as a cause for bank deleveraging and asset liquidation. Despite the consensus that bank recapitalization should be part of the recovery from the debt crisis, concerns have been raised about the deleveraging incentives that reaching a 9 percent ratio capital target may induce, given the very unfavorable capital market

conditions facing the banking industry today, banks could rely more on asset shedding rather than on raising fresh equity capital. The worry is that the recapitalization package could enhance the possibility of a pro-cyclical response by the banking sector, thereby increasing the shift toward the credit crunch (Goldstein 2012; Acharya, Schoenmaker, and Steffen 2011). Preliminary evidence supports both these hypotheses, though proper examination and assessment will need to wait until the conclusion of the crisis.

In assessing the extent to which recent policy and regulatory initiatives have helped stabilize European bank funding market conditions, developments in the term bond and interbank markets—two markets generally viewed as the barometer of investor sentiment—have shown signs of thawing since the start of 2012. Banks' long-term bond issuance, which virtually collapsed in the second half of 2011, has picked up modestly (figure 5), with 125 bond issues totaling \$56.7 billion in the first one and half months of 2012.

On the short end of the maturity spectrum, the ECB's efforts to improve liquidity conditions in the euro area money market through its three-year longer-term refinancing operations (LTRO), first allotted on December 21, 2011, seem to have had a decisively positive impact in mitigating the refinancing risk facing many European banks with large amounts of maturing debt (figure 6).

Figure 5. Bond Issuance by Euro Area Banks, January 2006 – January 2012



Source: Dealogic DCM.

Table 3. Downgrades in European Banks' Credit Ratings

Large	Moderate	Small
Banco Pastor (Spain)	Dexia (Belgium)	Erste Bank (Austria)
Caja de Ahorros del Mediterraneo (Spain)	Commerzbank (Germany)	Österreichische Volksbank (Austria)
Marfin Popular Bank (Cyprus)	HSH Nordbank (Germany)	WGZ Bank (Germany)
Banco Comercial Portugués (Portugal)	Banco Popular Español (Spain)	Banco Santander (Spain)
Banco BPI (Portugal)	Caja España de Inversiones Salamanca y Soria (Spain)	BBVA (Spain)
EFG Eurobank Ergasias (Greece)	Allied Irish Banks (Ireland)	Banco de Sabadell (Spain)
National Bank of Greece (Greece)	Banca Monte dei Paschi di Siena (Italy)	Bankinter (Spain)
Alpha Bank (Greece)	Unione di Banche Italiane (Italy)	Caja de Ahorros de Ronda, Cadiz, Almeria (Spain)
Piraeus Bank (Greece)	Nova Kreditna Banka Maribor (Slovenia)	Caja de Ahorros de Vitoria y Alava (Spain)
Caixa Geral De Depósitos (Portugal)	Landesbank Baden-Württemberg (Germany)	
	Norddeutsche Landesbank (Germany)	
	Caja de Ahorros y Pensiones de Barcelona (Spain)	
	Intesa Sanpaolo (Italy)	
	Banco Popolare (Italy)	
	Nova Ljubljanska Banka (Slovenia)	
Average exposure to home country (%) ^a	176	285
Average exposure to GIP (%) ^b	152	16
		243
		9

Source: Credit ratings were sourced from Bloomberg and refer to issuer and long-term deposits ratings.

Note: Downgrades refer to credit rating changes between January 1 and November 30, 2011.

a. Exposure defined as the ratio of a bank's gross direct sovereign debt holdings relative to its core tier 1 capital.

b. GIP: Greece, Ireland, and Portugal.

Over the longer term, prospects for European banks to have access to private capital markets on a sustainable basis will depend not only on building an additional capital buffer for banks to withstand the current volatility, but on the continuing role of ECB in keeping the interbank market functioning smoothly and on the implementation of broader measures to improve the ability of bank resolution regimes to more effectively manage the failure of a systemically important financial institution (SIFI) without putting taxpayer money at risk. The heavy economic costs borne by taxpayers in advanced countries as the result of the bank rescue packages of 2008–9 have dampened political will and capacity for future bail-outs of banking institutions,

even those with systemic risk attributes. Avoiding moral hazard risk has become the new mantra of public policy in dealing with problem banking institutions. Along with more concrete measures to strengthen supervisory mandates and improve risk management practices in financial firms, the new policy framework, endorsed by G-20 leaders in Seoul, calls for expanding the capacity of authorities to resolve problems with SIFIs in an orderly fashion, without putting public finances at risk. By ensuring that creditors share the adverse consequences of bank failure, such measures are likely to strengthen market discipline and reduce banks' incentives for taking on excessive risk.¹

Combining Market Discipline with Institutional Solutions

The euro area sovereign debt crisis has exposed both institutional and market failures. On the institutional side, inability to ensure compliance with the Stability and Growth Pact (under which EU member states agree to limit their budget deficits to no more than 3 percent of their GDP and ensure that their national debt does not exceed 60 percent of GDP) represents a serious governance shortcoming, one that was highlighted and debated well in advance of the crisis.² At its core, the agreement reflects the asymmetric institutional design of the EMU, in which member states are bound by a monetary union, but each retains a domestic fiscal apparatus. It also reflects the fact that the EMU was seen from its outset as more than an economic project (Verdun and

Christiansen 2000; Wyplosz 2006; Henning 2000). As often emphasized by scholars and commentators, the rationale for establishment of the EMU is appropriately viewed in the broader geopolitical terms of contemporary era—as a means of promoting political integration within Europe, as a step toward establishing the euro as a counterweight to the dollar, and as a shield against macroeconomic policy volatility emanating from the United States.

The political dimension of sovereign debt crises, a well-recognized feature of democratic societies rooted in the Westphalian system of nation-states, is at the forefront of Europe's crisis, not just as a result of the supranational design of EMU

Figure 6. European Sovereign and Bank Funding Markets' Reaction to ECB LTRO: January 2010 – January 2012



Source: Based on data from Bloomberg.

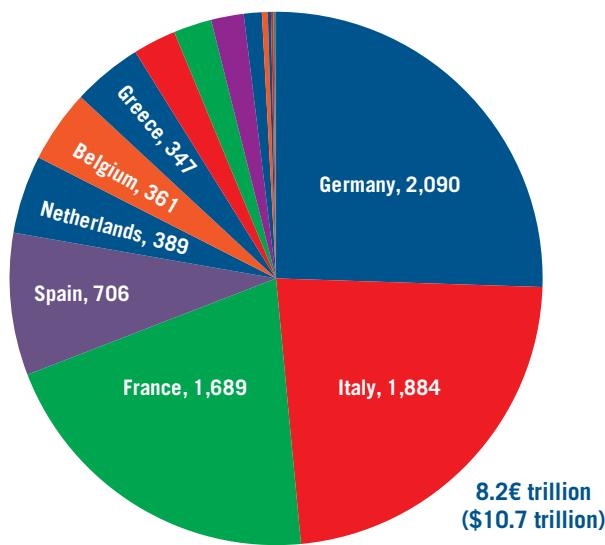
institutions, but also because of the “no-bail-out clause” instituted as a pillar of the EU’s fiscal discipline and good governance. With euro area economies growing at an average annual rate of 2.2 percent from 2000 until the breakout of global financial crisis in 2008, the single currency steadily gaining international traction, and large amounts of foreign capital financing the growing current account deficits of countries such as Greece, Portugal, and Spain, the resilience of the EMU structure did not undergo a true market stress test until the current crisis.

In a climate in which markets have now become, along with citizens, the arbiter of political decisions in euro area member states, the broad division of responsibility for monetary policy at the ECB level and responsibility for fiscal and budgetary discipline at the level of member states (albeit under some broad common rules) are likely to require rethinks. Though some proposals for the ECB to backstop euro area sovereign debt (Wyplosz 2011) go well beyond the rationale and logic of ECB intervention in public debt markets on monetary policy implementation grounds (and thus could trigger adverse market backlash and opposition from euro area creditor governments), there is little doubt that the ECB’s enhanced role in providing liquidity to the banking system at a favorable rate could have indirect positive implications for sovereign debt markets, as evidenced by the success of the LTOR operation. With markets gaining confidence and seeing clarity on the resolution of the banking side of the European debt crisis, investors with high-risk appetites could enter the periphery debt markets, thereby pro-

viding the demand necessary for recovery, and presaging purchases by traditional institutional and overseas investors.

As leaders seek to formulate a new consensus on fiscal governance in the process of chasing an orderly outcome to the crisis, market discipline can complement their efforts in creating a more sustainable euro area sovereign debt market. Achieving sustainability is important because of the size and status of euro area markets. With an aggregate size of €8.2 trillion (\$10.7 trillion) as of the end of third quarter 2011 (figure 7), the euro area sovereign debt market is comparable to the market for U.S. treasuries in size, and now serves as the second pillar of global fixed-income markets, capable of attracting large overseas capital by virtue of the reserve currency status of the euro. In a world in which the majority of emerging and developing countries operate under some variety of managed floating exchange rate regimes and demand for self-insurance remains strong, there is a structural demand for euro-denominated assets from oil exporters and emerging Asia, particularly for high-rated sovereign debt instruments. From this perspective, the range of crisis management and prevention measures recently introduced among banks and distressed sovereign borrowers is likely to go a long way in allowing investors in euro area sovereign bonds to price the credit risk of individual member states in line with national metrics such as growth prospects, debt sustainability, international competitiveness, banking system health, and political risk, thereby allaying the need for exclusive reliance on centralized rule making to improve fiscal governance.

Figure 7. Euro Area Sovereign Debt Market Size, Outstanding Government Debt, as of Third Quarter 2011 (euro billions)



Source: Eurostat government statistics.

About the Author

Mansoor Dailami is lead author of *Global Development Horizons*, and Manager of the *Emerging Global Trends Team*, part of the *Development Economics* (DEC) at the World Bank. This note is part of a larger ongoing study, *Rethinking the Sovereignty of Sovereign Credit*, which explores the question of why global investors have traditionally underestimated the sovereign risk of advanced countries and the implications of investors' abrupt reaction to incidences of heightened sovereign risk.

Notes

1. There is extensive literature that relies on wholesale funding markets to gauge the extent and nature of bank risk. That literature, prompted by the market discipline approach to bank regulation, argues that capital markets contain timely and useful information on the risk characteristics of banks tapping wholesale funding markets (see for example, Jagtiani, Kaufman, and Lemieux [2002]; Demirguc-Kunt and Huizinga 2009.)
2. Since the publication of the Delors report, *One Market, One Money*, in 1990, there has been a voluminous literature on various aspects of the EMU, including legitimacy (Sadeh, Jones,

and Verdun 2007), democratic deficit (Majone 1998; Moravcsik 2002; Follesdal and Hix 2006), and enlargement (Cohen 2007).

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