



MONETARY POLICY IN THE CONTEXT OF THE EUROPEAN SOVEREIGN DEBTS

PhD Adina CRISTE*

Rezumat

Criza datoriilor suverane în Europa a generat pentru politica monetară a Băncii Centrale Europene (BCE) o serie de provocări legate de menținerea stabilității prețurilor și de încurajarea activității de creditare a economiei, într-un mediu destul de incert, cu investitori precauți și în condițiile în care sustenabilitatea fiscală a statelor din zona euro este profund afectată.

Lucrarea tratează problematica efectelor în plan monetar generate de criza datoriilor suverane din zona euro, pornind de la descrierea pe scurt a evoluției pieței obligațiunilor suverane europene începând cu perioada realizării proiectului zonei euro. Particularitățile mecanismului de transmitere a politicii monetare provocate de efectele crizei datoriilor suverane pun în evidență anumite constrângeri ale politicii monetare în etapa actuală.

Articolul se înscrie în sfera problematicii complexe legate de procesul integrării monetare și a funcționării zonelor monetare optime.

Abstract

The crisis of the sovereign debts in Europe challenged the monetary policy of the European Central Bank (ECB) to maintain price stability and to encourage the credits for economic activities under the conditions of a rather uncertain environment with precautionary investors and under the conditions of faltering fiscal sustainability of the Euro Area member states.

* *Scientific researcher III, "Victor Slăvescu" Centre for Financial and Monetary Research, Romanian Academy.*

The paper approaches the issue of the monetary effects generated by the crisis of the sovereign debts within the Eurozone starting with a brief description of the European sovereign bonds market, starting with the period before the euro project implementing. The particularities of the monetary transmission mechanism caused by the effects of the sovereign bonds crisis reveal specific constraints of the current monetary policy.

The article is subject to the complex issues related to the monetary integration process and the operation of the optimum currency areas.

Keywords: price stability, monetary transmission mechanism, sovereign bonds

JEL classification: E44, E52, H63

This paper is based on the activity conducted for the accomplishment of a chapter from the research project “*Determinations, constraints and conditionalities of the project of European financial-monetary integration within the present circumstances*”, elaborated in 2012, within “Victor Slăvescu” Centre for Financial and Monetary Research

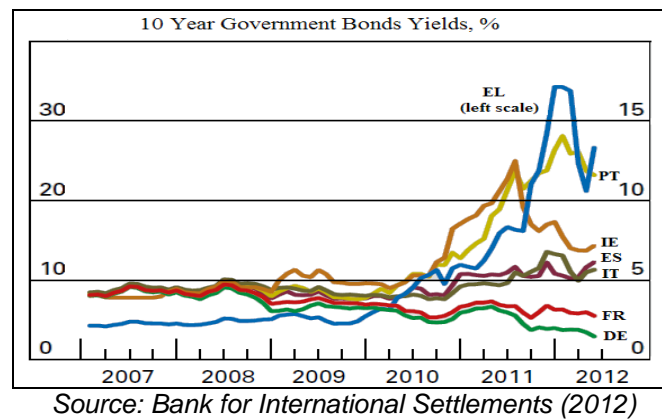
From the monetary perspective, the global financial crisis determined the reduction of the nominal short-term interest rates in the developed countries. The monetary policy measures aiming to correct the imbalances of the financial market and to stimulate the economies determined a spectacular increase of the central banks' balance sheets due to the higher issues of reserves by expanding the refinancing operations for the credit institutions. In some Euro Area countries, the fast increase of the public debt increased the interest rate differentials, and this triggered a spiral of adverse effects and expectations, increasing the amounts to be paid, thereby it amplified the increase of debts, and so on.

1. The evolution of the sovereign bonds market in the Eurozone countries

Overall, the Euro adoption generated excessive imbalances, which show a poor allocation of the resources. This established an environment favourable for the propagation of the *shock of*

uncertainty, in the autumn 2008 (the Lehman Brothers bankruptcy) and for the start of the sovereign debts crisis starting with 2009.

Figure 1
Evolution of the interest rate for the long-term governmental bonds in Eurozone countries



Until the period of preparing the Euro project (until 1996), the interest rates for the bonds issued by the European governments were divergent due to the manifestation of the two types of risks: the currency risks (due to the circulation of the national currencies) and the risk related to the payment of the sovereign debt. After the adoption of The Stability and Growth Pact and before the Lehman Brothers bankruptcy (between 1996 and 2008), these interest rates have converged due to the expectations for eliminating the currency risk, which created false expectations regarding the low investment risk. Practically, the elimination of the depreciation risk determined the undervaluation of the risk for default of the sovereign debt. The trend of the interest rates' convergence has been maintained after the Euro adoption, despite the differences between countries in terms of economic fundamentals and fiscal position. The explanation of the similar yields of the bonds issued by the national governments lies in the expectations of the investors during a period of low macroeconomic volatility (period also known as the "Great Moderation") which excluded the possibility of extreme events causing the incapacity of a country from the Eurozone to refinance its debt. This favourable period also determined a low level of the risk aversion and low risk premium for the different categories of assets. The development of the market for the Euro denominated bonds,

together with the expansion and diversification of the currency reserves probably have created a false perception for a perpetual increase of the demand for sovereign bonds.

After the Lehman Brothers bankruptcy, a new period of diverging interest rates for sovereign bonds has started, due to the different revaluation of the risk default for debt issued by the different European governments. Practically, the *uncertainty shock* has fragmented the financial markets of the Eurozone, as shown by the increased differential of the interest rates, while the European political context, with the disputes and delays regarding the salvaging plans initiated by the Euro Area authorities, maintained the differences of the interest rates for the government bonds.

The differential of the interest rates for the sovereign bonds during the financial crisis reflects the way in which Euro Area is working. After giving up to the monetary policy sovereignty, the tensions from the financial markets have actually passed to the market of the sovereign debts, and the currency risk existing before the Euro adoption was replaced by the sovereign risk. In other words, the interest rates differential available before the Euro adoption was determined by the fear for exchange rate depreciation of national currencies, while the present interest rates differential is caused by the fear for sovereign debt default.

Overall, the factors which generated and fuelled the crisis during this period are a combination of frail economic fundamentals and market distortions determined particularly by the procyclic character of the financial market functioning¹.

¹ *It was noticed in time that the functioning of the financial market is procyclical, due to its tendency to exaggerate the perception of the risk one way or another, further amplifying these trends. Thus, during the "optimistic" periods, the risk appetite is high, the economic conditions are favourable and the assets price tends to be high, while the risk is low. This trend probably led to an excessive convergence of the yields for the bonds denominated in Euro during the period before the Euro adoption. During the unfavourable periods, with a higher risk aversion, the rate of the economic growth (GDP growth rate) decreases and the assets price tends to decrease. Somehow or another, the investors will amplify the trends. Such procyclical behaviour also affected the market of the sovereign bonds during the period of the current crisis. The use of the sovereign bonds as collateral has also produced adverse effects on other segments of the financial market (for instance, financing of the financial institutions).*

The sovereign debt crisis in the Eurozone has intensified after the second half of 2011, when the official creditors compelled the private sector to get involved in the reduction of the Greek debt burden as condition for new credits. Besides the higher uncertainty of the bond investors, the economic growth of the Eurozone was not spectacular, so that the Eurozone governments found it difficult to strengthen their financial position in the near future. The tensions manifested during this period generated a feeling of uncertainty regarding the bank exposure to the sovereign credit risk and the incapacity of the governments to support vulnerable banks. The credit default swap premium of the European banks increased suddenly as a consequence of the deteriorating the perception on the bank reliability. The price of the shares issued by the credit institutions from Eurozone has generally decreased, stronger in the countries with sovereign debt problems (Spain, Greece and Portugal), while the financing conditions from the banking system have been deteriorated further when the deposit holders started to withdraw their savings from the Spanish, Italian, Greek and Irish banks. The market for unsecured debts closed for many banks from the Eurozone, while the cost of loans on the interbank market increased significantly not only for the Euro, but also for the US Dollar and the Pound Sterling.

The political initiatives from this period (resuming the program of governmental bonds acquisition, higher use of the Eurozone stabilisation fund and increased crediting capacity of this stabilization fund) tried to alleviate the intensity of the crisis, but they didn't generate the expected results. The effects were on the short-term because of the investors distrust in the capacity of the governments to apply the measures of fiscal consolidation agreed with the European partners. However, in late 2011, the announcement of the fiscal compact to limit the deficits of the structural budgets² had a stronger and a more sustained effect of reducing the yield of the sovereign bonds.

² *The European fiscal compact is part of the Treaty on stability, coordination and governance of the Economic and Monetary Union (finished in January 2012). The purpose of the treaty was to consolidate the fiscal discipline throughout Europe by imposing sanctions and by a strict budgetary-fiscal monitoring of the member states.*

2. The European crisis of the sovereign debts and the monetary transmission mechanism

Given the strong financial fragility and the mistrust with respect to both the debt payment capacity of some Eurozone member states and the measures to support them by the other member states, the investors imposed higher interest rates for the sovereign bonds from the vulnerable countries. If the risk premium would exceed a specific limit, they would reduce the exposure to the issuers of such bonds. The financial instability disturbs the monetary transmission mechanism altering the transmission of the monetary policy stance upon the financing conditions.

The government bonds play a key-role in the transmission of the monetary policy towards the real economy through the interest rate channel. During the favourable periods, when the government bonds are considered risk-free and liquid instruments, a change of the monetary policy interest rate influences the yield of these bonds. These long-term changes are transmitted to some extent to the yields of the bonds issued by companies and to the interest rates of the bank loans, thus ensuring the transmission of the monetary policy to financial markets.

However, since the end of 2008, there was a change in this relation. The behaviour of some sovereign issuers started to be dominated by high and volatile risk premiums, as an effect of the contagion phenomena and as an exaggerated reaction of the markets. Such effects tend to go beyond the influence of the monetary policy framework. The changes of the monetary policy behaviour no longer play the leading role in determining the evolution of the government bonds yield. Thus, the monetary policy signal transmitted on the real economy is disturbed.

The government bonds have been an important source of guarantee for the credit institutions, being used to credit other banks and in the relations with ECB.

A significant share of the financial assets from the balance sheets of the commercial banks in the Eurozone represent bonds issued by their own governments, being considered low-risk securities. The financial turbulences, however, produced a differentiation of the risk level as a response to the investors' perceptions regarding the vulnerability of the economy of the issuing country. As a reaction to the uncertainty shock, the investors used the "flight to quality" approach, generating even so higher gains as the higher is the share

of bonds issued by the countries with solid economy in the total financial assets of the bank. The increase of the interest rates differentials for the sovereign bonds may determine a phenomenon of polarization in the monetary area, thus increasing the risk of political divergences between countries, entailing a deeper crisis.

The price of the government bonds from the vulnerable countries has decreased significantly, with the downgrade the country risk level. The exposure of the banks to the government debt has thus a direct adverse impact on the assets from the bank balance sheet, and implicitly on their net wealth. Such situation increases the risk of a disordered disintermediation that may produce a credit crisis within the banking system. In other words, the increase of the sovereign risk influences directly the banking risk. In turn, the banks confronted with a higher banking risk have higher refinancing difficulties and this will increase the burden over the governments. Such vicious circle between the perception of the sovereign risk and that of the banking risk affects the credits for the real economy.

When the banking sector represents the main financier of the economy, as it is the case of the member states of the Euro Area, it is expected a decline of the economic activity and these expectations could become self-fulfilling: as soon as the companies and the households expect a slower growth, they also expect the public budget to be affected, as the revenues decrease. The pessimistic scenario might also increase the risk premium for the government bonds which, correlated with the private debt, reflect directly in the interest rates paid by the private sector. Even if the interest rate policy will remain close to zero, the economic activity will not be stimulated. Such a phenomenon has occurred in the Euro Area. The conjuncture of the increasing interest rates has created pessimistic expectations regarding the economic activity in the European countries.

Another reaction to the significant decrease of the price for the sovereign debts is the increased consumers' propensity to save for precautionary purpose given the adverse expectations regarding the lending activity of banks. Such behaviour counteracts the potential measures for monetary policy easing applied for stimulating the consumption.

Since 2011, the cost of bank credits for companies increased suddenly in Spain and Italy. It coincided with an increasing of the interest rates for sovereign bonds issued by Spanish and Italian governments, against the German reference.

These trends show practically the break or disruption of the relation between the monetary policy decisions and the financial market, damaging the monetary transmission mechanism.

3. Constraints of the monetary policy within the Euro Area

The constraints of monetary policy within the current European conjuncture refer to the “narrowing” monetary space under many aspects:

- Increased burden for monetary policy regarding the economic stability, given the narrow space of the monetary policy to use the interest rate, which is near zero;

- Increased inflation pressure, raising the uncertainty regarding the ability of the central bank to maintain price stability, given the intervention of central bank for the payment of the sovereign debt using its balance sheet assets. Such a circumstance would hit the credibility and the independence of the central bank. At the Euro Area level, there is presumably no monetary dominance; therefore the price stability objective has priority over the general objective of avoiding the state of default, which eliminates the risk of losing this independency.³

- Increased risk perceived about the public debt, which affects the proper functioning of the financial markets and the transmission of the monetary policy, as shown above.

The financial turbulences and the uncertainty existing during the first stage of the crisis from the interbanking market generated liquidity problems even for the solvable banks. In such uncertain environment, the use of the conventional instruments of the monetary policy is no longer efficient to correct the blockages from the financial markets. In this situation, the European Central Bank implemented non-standard measures to ensure the liquidity in the damaged segments of the market and in order to restore the proper adequacy of the monetary transmission channels. Due to the insufficient information for evaluating the need of competitors' liquidity, the credit institutions from Euro Area started to accumulate large amounts of liquidity and to refrain from taking loans from the interbank market.

³ *It remains to be seen the “price” of maintaining this monetary dominance. Practically, in the view of the central authority of the Euro Area, the central bank independency is more important than the risk of default for sovereign debt of the member states.*

The banks were under pressure that the liquidity problems could turn into default, and the monetary policy started to focus on holding reserves rather than on the nominal interest rates. In such circumstances, the risk of disorderly deleveraging leading to a credit crunch in banking sector of the Euro Area increased significantly, in early 2012 (European Commission, 2012).

When the interest rate of the monetary policy reached or is close to its minimum level (zero), the stimulation of the economic activity can be achieved by applying some measures of the monetary policy. According to Bernanke and Reinhart (2004), there are three such measures:

- Reassuring the investors that the short-term interest rates will remain lower in the future than they currently expect and this creates favourable expectations;
- Modifying the securities supply in the market place by changing the composition of the central's bank balance sheet;
- Increasing the size of the balance sheet beyond the level needed to set the short-term policy rate at zero. This is a strategy of *quantitative easing* (QE). The manner of QE implementation differs from country to country, depending on the specificity of the interactions between the banking system and the monetary authority and on the main targets of the monetary policy.

At the European level, QE policy meant an expansion of the **refinancing operations of the central banks from the Eurosystem, by providing liquidities, large amount of credits (unlimited), at flat interest rates.**

During the second part of 2011, as the tensions from the financial markets increased, the ECB decided to resume the application of nonconventional measures of monetary policy, such as the *Securities Markets Programme*, broadening the range of assets accepted as eligible collaterals in its refinancing operations in order to secure the following objectives:

- Reducing the maturities on the monetary market;
- Loosening the financing conditions for the credit institutions and for the companies;
- Encouraging the banks to maintain or even to develop the credit activity to the private sector;
- Improving the market liquidities on important segments of the private debt securities.

Cecioni, Ferrero, Secchi, (2011) stated that the unconventional measures of monetary policy contributed to the support of the financial intermediation in the Euro Area by ensuring the refinancing of the solvable credit institutions and by restoring the trust between the market players.

4. Some conclusions

The very manner in which the Eurozone is designed to function represents one of the main causes of the current sovereign debts crisis, by giving up on the independent monetary policy, so that the tensions from the financial market actually migrated towards the market of the sovereign debts, and the currency risk existing before the Euro adoption was replaced by the sovereign risk. While before the Euro adoption the gap between the interest rates was determined by the fear of exchange rate depreciation, as the national currencies were still circulating, during the current period this gap is determined by the fear of the sovereign debt default.

The increase, or at least the maintenance, of the interest rates differentials for the sovereign bonds between the Eurozone countries may determine a phenomenon of polarization in the monetary area, thus increasing the risk of political divergences between countries, entailing a deeper crisis.

The misbalances generated by the current crisis of the sovereign debt from the public and private sector have implications on the financial stability and implicitly on the management of the monetary policy.

The monetary policy constraints are determined on the one hand by the narrowing of the monetary “space” of manoeuvre, and on the other hand by the fact that the price stability, the fundamental objective of the European Central Bank, can no longer be considered enough to ensure the financial stability.

The unconventional measures implemented by ECB during the crisis didn't distort the general framework of the monetary policy strategy, but completed it, noticing the relation of complementarity with the interest rate policy during financial crisis.

The sovereign debt crisis, as Goodhart was noticing during the 1990 years (Goodhart, 1997), is another proof for the fact that the break of the relation between the fiscal authority and the monetary authority – the two key-elements that define the political authority of a state – determined by the establishment of the Economic and

Monetary Union, affects the position of the sovereign debt market of the participating countries.

References

1. Central European Bank (2012) – *Annual Report, ECB, 2011*, Central European Bank, Frankfurt am Maine.
2. Central European Bank (2011) – *Financial integration in Europe*, Central European Bank, May 2011, Frankfurt am Maine.
3. Bank of International Settlements (2012) – *82nd Annual Report 1 April 2011-31 March 2012*, BIS, 24 June 2012, Basel.
4. Barbosa, L. and S. Costa (2010) – *Determinants of sovereign bond yield spreads in the euro area*, Banco de Portugal, Economics and Research Department, Working Papers 201022.
5. Bernanke B. S., V. R. Reinhart (2004) – *Conducting Monetary Policy at Very Low Short-Term Interest Rates*; The American Economic Review, vol. 94, nr. 2.
6. Borge V., L. Laubach, J.-S. Mésonnier, J.-P. Renne (2011) – *Fiscal sustainability, default risk and euro area sovereign bond spreads markets*, Banque de France, Working Paper 350.
7. Cecioni M., G. Ferrero, A. Secchi (2011) – *Unconventional monetary policy in theory and in practice*, Banca d'Italia, Occasional Papers, nr. 102, September.
8. European Commission (2012) - *European Economic Spring Forecast. European Economy 1*, European Commission, May 2012, Brussels.
9. De Grauwe P. (2011) – *The Governance of a Fragile Eurozone*, CEPS Working Document, nr. 346, Centre for European Policy Studies, May 2011, Brussels.
10. Freixas, X., C. Giannini, G. Hoggarth, F. Soussa (2000) – *Lender of Last Resort: What Have We Learned Since Bagehot?* Journal of Financial Services Research, Vol. 18, nr. 1, pp. 63-84.
11. Goodhart C.A.E (1997) – *Two Concepts of Money, and the Future of Europe*, in: Blejer, M.I.; Frenkel, J.A. Leiderman, L.; Razin, A.; Cheney, D.M. (ed.), **Optimum Currency Areas. New Analytical and Policy Developments**, (pp. 89-96). Washington D.C.: International Monetary Fund.
12. Matheron J., B. Mojon, J.-G. Sahuc (2012) – *The sovereign debt crisis and monetary policy*, Banque de France, Directorate

Monetary and Financial Analysis, Financial Stability Review nr. 16, April.

13. Panetta F. (coord.) (2011) – *The impact of sovereign credit risk on bank funding conditions*, Committee on the Global Financial System, CGFS Publications, nr. 43, July.
14. Stock, J. and Watson, M. (2002) – *Has the business cycle changed?* NBER Macroeconomics Annual, Vol. 17, pp. 159-218.