Financial Fragmentation in the EuroArea: Sources, Implications & Policy Responses

Klaus Adam
University of Mannheim & CEPR
Outline

- Financial fragmentation: many dimensions
- Looks plausible that sovereign risk a common cause
- Has important implications of how FM fragmentation can be addressed by national governments, ECB & regulators
The Many Faces of Fragmentation

- **Financial sector**
  - unsecured interbank lending (and repo) rates diverged
  - issuance of unsecured senior debt fell, esp. in distressed countries
  - cross border holdings of debt securities decreased

- **Corporate sector**
  - country risk premia in corporate bond markets
    in line with risk premia in sovereign bond markets

- **Sovereign debt markets**...
"...whatever it takes..."
Common Cause for Fragmentation?

Fragmentation easily explained by sovereign default risk ("restructuring" risk, EA exit risk)

- **Banking Sector:**
  - Country exposure determines unsecured lending & repo rate
  - Large home country sovereign exposure:
    - search for correlated risk => int‘l disintermediation
  - Inability to issue unsecured debt or too costly relative to alternative funding sources (ECB repos)

- **Corporate Sector:**
  - Sovereign risk implies private default risk: corporate bond spreads
Fragmentation due to sovereign risk?

- Policy measures addressing fragmentation in the financial & corporate sector (banking union/SSM)
  
  "symptomatic treatments"

- Possibly useful but ultimately unable to address cause of problem
Fragmentation due to sovereign risk?

- Big hope associated with SSM: win-win situation
  
  *Eliminate private premia, improve domestic situation*
  
  *(corporate & financial sector), thereby also lower sovereign premia*

- Rests on weak foundations:
  
  - *somebody must hold sovereign risk*
  
  - private risk cannot be eliminated by SSM if the source of risk is sovereign risk.
Key to Eliminating FM Fragmentation...

.... is elimination of sovereign risk:

1. Fundamental Risk

2. Debt Rollover Risk

3. EA Breakup Risk
Key to Eliminating FM Fragmentation....

.... is elimination of sovereign risk:

1. Fundamental Risk: fiscal policy

2. Debt Rollover Risk: monetary policy

3. EA Breakup Risk: monetary & fiscal policy
1. Fundamental Risk

• **Classic fundamentals:**
  Debt, deficits, implicit banking liabilities, growth prospects
  =>$c$ountries acting on these have been rewarded:
  Portugal vs. Greece

• **Political fundamentals:**
  Credibility & predictability of domestic policies
  „degree of commitment to repay“
  =>$c$hould be much harder to control in a democratic process
PT gov bond, maturing 2023, 4.95% coupon, actively traded
July 1, 2013: Finance Minister Vítor Gaspar resigns, Treasury Secretary Maria Luis de Albuquerque nominated as successor.

Price next day: -1.2%
July 2, 2013: Paulo Portas, foreign minister and head of junior coalition party CDS-PP, resigns in protest of nomination of Maria Luis de Albuquerque.

Price next day: approx. -6%
July 7, 2013: PM Coelho proposes to make Paulo Portas vice premier
July 11, 2013: President Silva refuses PM plan, wants “national salvation government” including socialist opposition party.
July 24, 2013: President Silva accepts new cabinet with Maria Luis de Albuquerque as finance minister
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1. Fundamental Risk

- Political risk appears hugely important
  - credibility & reliability key

- Little that monetary policy can do about...

  MP could in principle provide incentives for fiscal reform
  e.g. via conditional bond purchase programs (OMT)
  But: such programs are bound to run into time-inconsistency
  problems generated by fiscal behavior
2. Debt Rollover Risk

- Financially sound sovereign has to rollover its debt:
  "strike" of bond buyers
  => cannot rollover debt
  => justifies "strike" (Cole & Kehoe, REStud 2000)

- CB: can insure good equilibrium as a lender of last resort

- EA: applied to each sovereign separately, if financially sound

- Classic & well-established CB role: not mentioned by ECB

- Why?
3. Euro Area Breakup Risk

- Comes in two forms:
  1. Self-fulfilling speculative attacks ↔ roll-over crisis
  2. Sovereign decides that prospects outside EA better
- First: should be (and has been) addressed by ECB
- Second: political risk, MP can not do much about
3. Euro Area Breakup Risk: Evidence

Euro-denominated invoices for goods imports

<table>
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<th>2010</th>
<th>2011</th>
<th>2012</th>
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<td>Greece</td>
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<td>38%</td>
<td>31%</td>
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<td>57%</td>
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<td>Spain</td>
<td>59%</td>
<td>62%</td>
<td>59%</td>
<td>53%</td>
<td>53%</td>
</tr>
</tbody>
</table>

No data for IE available, no recent data for IT available

Source: Table A12 in the „Int‘l Role of the Euro“ report, July 2013

No such trend in invoicing currency for goods exports…
Summary

- Key to eliminating FM fragmentation: Elimination of sovereign risk

- Some of this in the MP domain: Elimination of rollover & speculative EA break up risk

- FM fragmentation largely a fiscal phenomenon: Fiscal policies & their credibility