Implications of the European Crisis for the Single Financial Market

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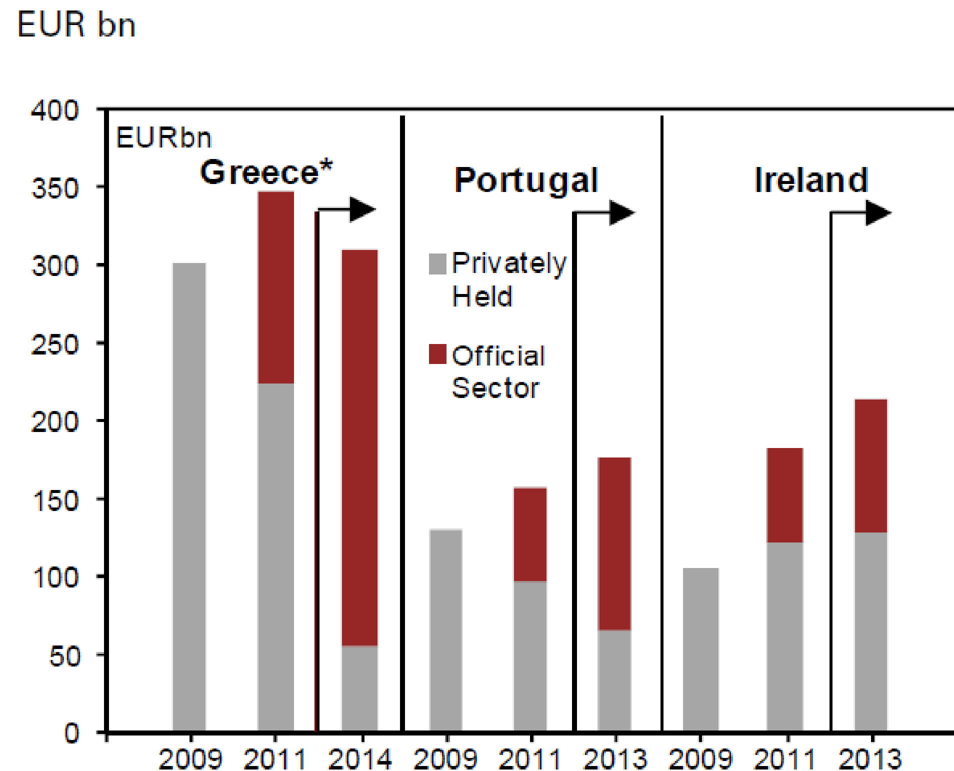
The Standard Financial System

- Sovereign debt is nominally free of repayment risk:
  - Because government has taxing power
  - Because of the implicit bailout by the central bank
- Sovereign bonds and bills provide benchmark riskfree term structure
- Banks hold sovereign debt as market makers and (in the short maturities) for transaction purposes (collateral): sovereign debt has zero risk weight
- Banks' liabilities are nearly riskless, because of deposit insurance and bank supervision (the interbank, unsecured market works well)
- Sovereign risk is reflected in inflation risk, which is priced in the nominal term structure

Europe's Sovereigns

- Partial and implicit mutualization of sovereign risk through EU holdings of program countries' debt (see Goldman Sachs figure on the right), and through SMP and, potentially, OMT

- Without full mutualization, spreads are bound to stay, albeit small



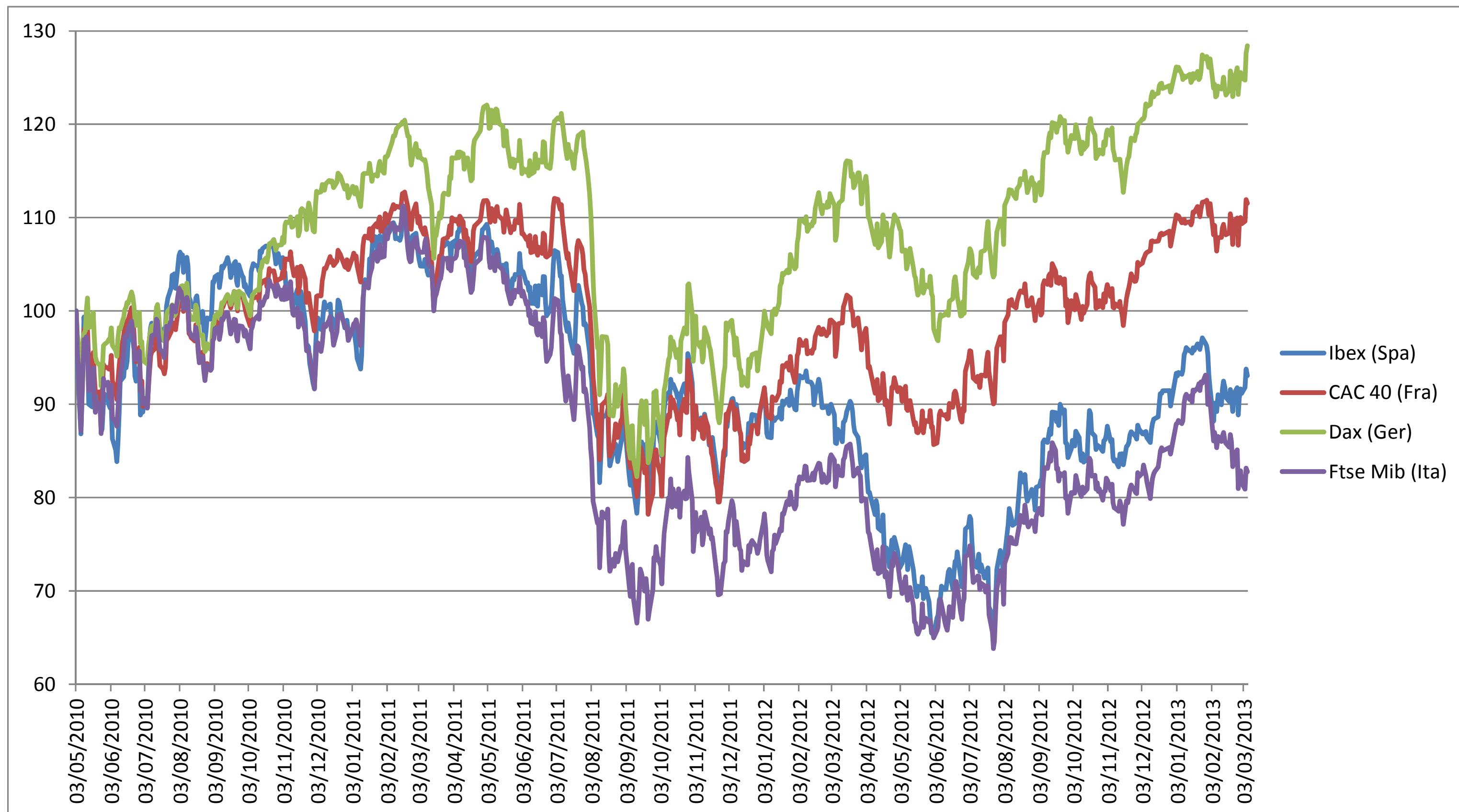
Source: Eurostat, GS Global ECS Research
** includes 2nd package + debt buy-back*

Europe's Banks

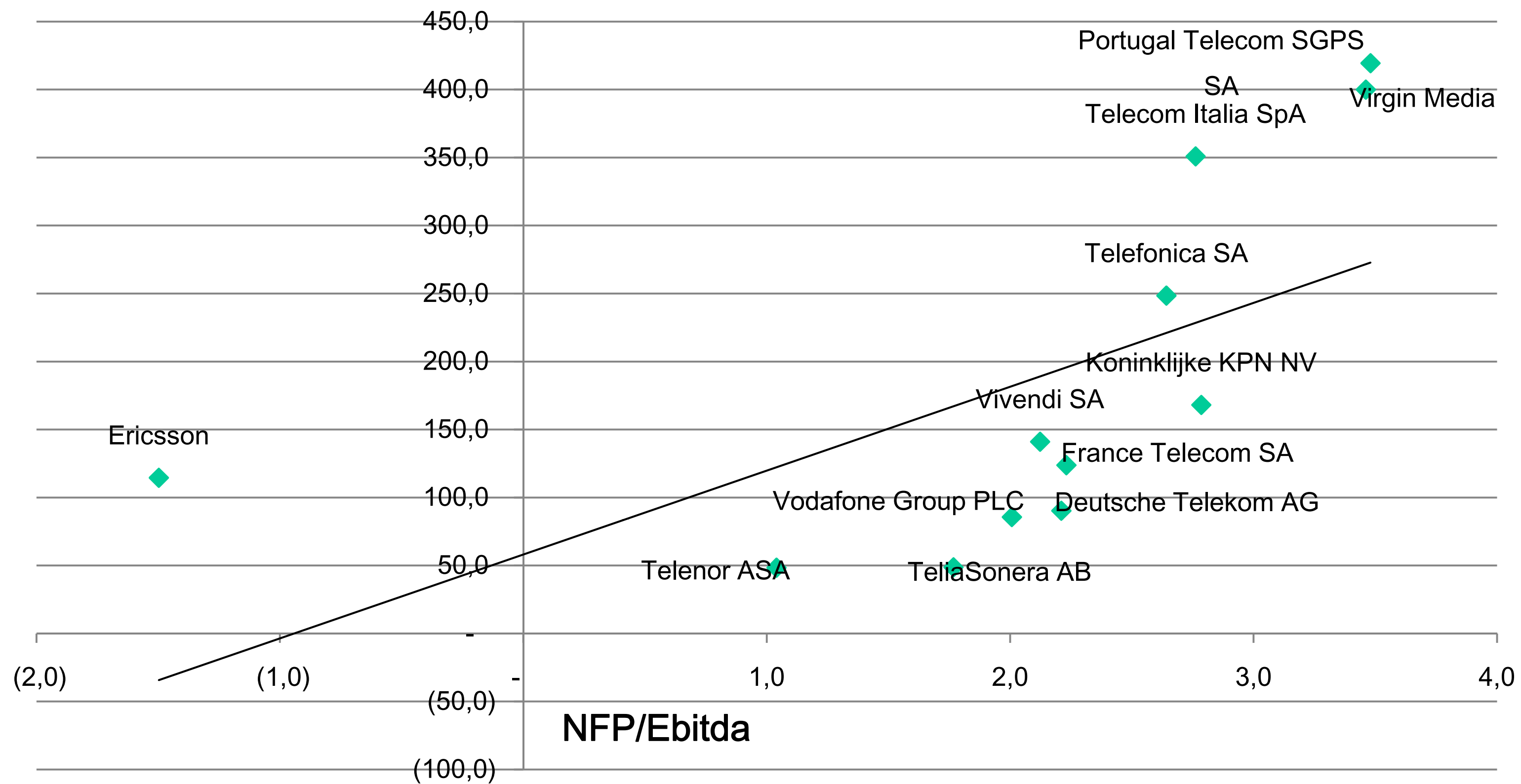
- Single supervisor to be followed by common deposit insurance and resolution mechanism?

- Banks are prevented by rules and practice to integrate fully within the Euro area:
  - Retail banks need to maintain a structure of subsidiaries
  - CRD directive limits intra-group exposures
  - Unicredit could not pool its treasury beyond the creation of 3 regional aggregates

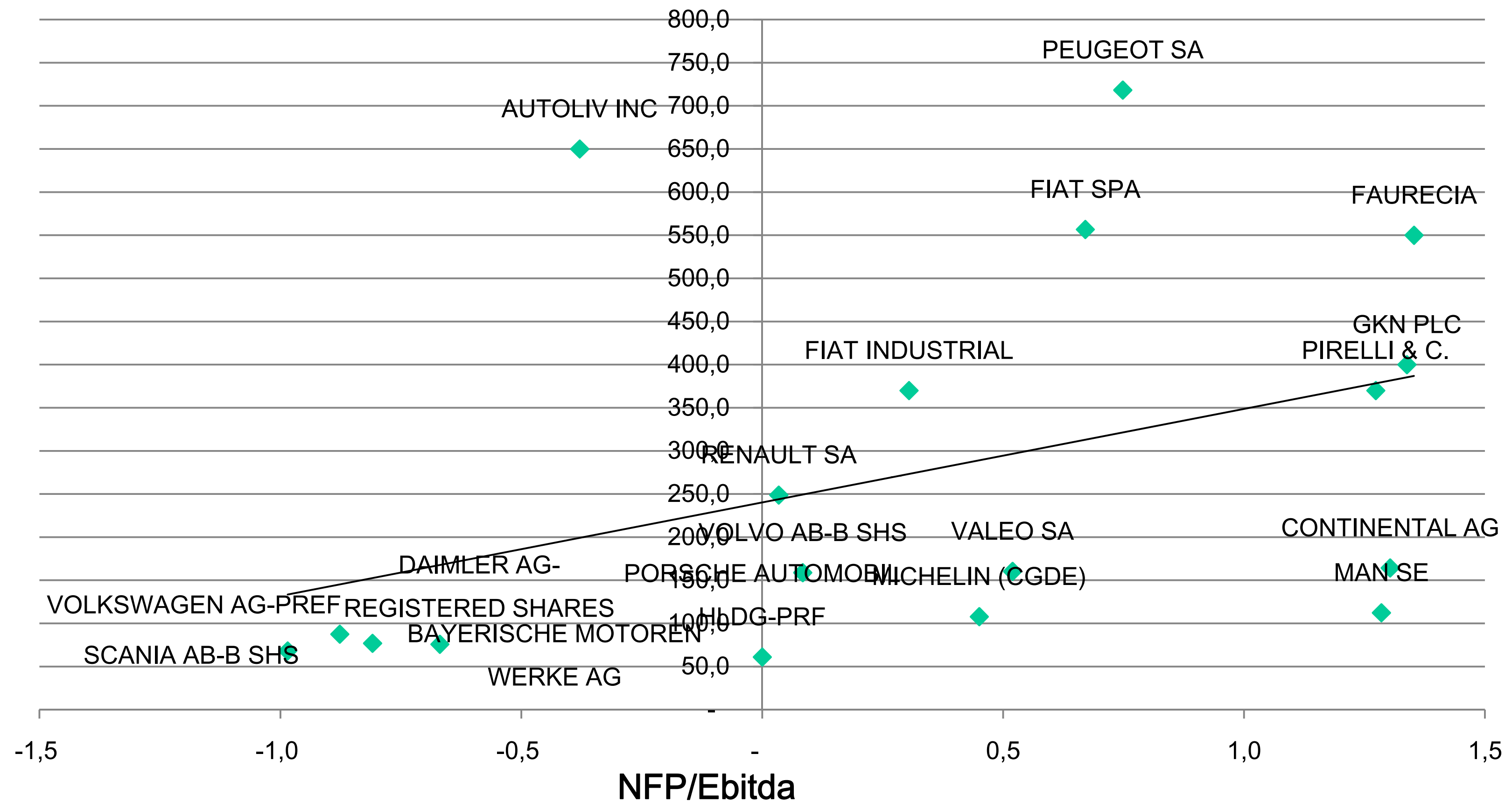
Equity TR Indices



5Y CDS Spreads: Telecoms



5Y CDS Spreads: Industrials



Interpreting the Data

- With benchmarks diverging, discount factors diverge, hence equity prices divergence
- With benchmarks diverging, bond yields diverge
- Equity indices have banks in them—perverse contagion between banks and sovereigns (by itself a signal of financial markets disintegration)
- Deteriorating credit and equity values in some countries could reflect the restricted availability of bank credit to these bond and equity issuers, making them riskier and generally less profitable
- Finally, these valuations could reflect the deterioration of the macroeconomic environment in those countries facing strained public finances.

Can the Standard Financial System Be Restored in Europe?

- Banking integration versus sovereign integration—in principle
- Banking integration versus sovereign integration—in practice
- The value of riskfree assets in the financial system