# THE CONFLICT RELATION BETWEEN THE SOVEREIGN DEBT OF THE EURO AREA COUNTRIES AND THE COMMON MONETARY POLICY AS A POTENTIAL SOURCE FOR GEOPOLITICAL CHANGES

**ADINA CRISTE, IULIA LUPU**
"VICTOR SLĂVESCU" CENTRE FOR FINANCIAL AND MONETARY RESEARCH, ROMANIAN ACADEMY, Bucharest,
a.criste@icfm.ro, iulia_lupu@icfm.ro

***Abstract:***
*The spreading of the uncertainty shock in the euro area caused changes in both domestic and external macroeconomic conditions, generating a set of constraints on macroeconomic policies. The purpose of this paper is to identify some constraints of relation between the common monetary policy and the sovereign debts crisis of the euro area countries. The identification of such constraints is helpful to the extent that it would signal potential conflicts between countries, assuming that the political dissensions are factors which could enhance the monetary disintegration and the geopolitical structure change. The euro area crisis impairs the geopolitical power of influence of Europe and compromises the negotiating position of the European Union on the world stage.*

***Keywords:*** *sovereign debt, common monetary policy, geopolitical changes*

***JEL classification:*** E52, F50, G01

## INTRODUCTION

After about four years when Europe is experiencing the effects of a financial crisis that has become a sovereign debt crisis, we see that it engenders some risks related to the euro area's size restriction and hence changes in the geopolitical sphere. The objective of this article is to identify some constraints regarding the relationship between the single monetary policy and the euro area sovereign debt crisis. The sovereign debt crisis is actually explained by the manner in which the Economic and Monetary Union (EMU) was designed, being that the Maastricht Treaty, the underlying agreement for the functioning of the monetary union does not stipulate liquidity provisions designed to serve as a shield against a potential financial crisis, forbidding to the national governments to borrow from the European Central Bank (ECB). Therefore, in the euro area, in the event of turbulence conditions in the banking sphere of a member country, the risk for default has been latent since the beginning of the currency area creation.

The uncertainty shock propagated in the euro area, which fueled the risk aversion, has caused a fragmentation of financial markets reflected by the increasing of the interest rates spread. Uncertainties about the bailouts initiated by the euro area sustained the differences between the interest rates for governments' securities. The interest rate spreads for euro area countries' sovereign debt emphasizes that, by giving up the monetary sovereignty, the financial market tensions were transferred to the sovereign debt market and the currency risk existing in the period before the euro adoption was replaced by the sovereign risk.

The risk of increasing and maintaining the interest rate differential for the sovereign bond could entail a phenomenon of polarization in the monetary area, amplifying the political dissensions between the member states, which would deepen the crisis. Thus, the single monetary policy in the euro area is facing some major challenges and dilemmas. Hannoun (2012) argues that policy responses to the crisis have exerted pressure on the monetary policy framework.

## THE SOVEREIGN DEBT CRISIS AND ITS EFECTS IN THE MONETARY FIELD

In autumn 2008, at the same time with Lehman Brothers bankruptcy, the interbank market in the euro zone has been "frozen" by the increasing preference for ensuring the banks' long-term liquidity. This phenomenon has severely altered the redistribution of funds in the interbank market. The "freezing" of the interbank market has further influenced the interest rates evolution in the longer term, including those for the government bonds issued by the euro zone countries, due to the distrust regarding the ability of some European countries to pay off their debts; the investors deemed that the euro could not guarantee the payment in full for their debt.

The fiscal sustainability impairment is reflected by the public debt increasing and by the deepening of the government deficit. Borgy et. al (2011) concludes that the fiscal factors explain the increasing of the differential between interest rates government bonds after 2008, due to investors' distrust concerning the ability of the governments from "vulnerable" countries to reduce their debt, considering that it has a limited space of action towards a fiscal stabilization. Basically, the public-debt burden creates by itself, without relying on weak economic fundamentals, the sovereign debt default risk.

The behavior of the financial markets and of the rating agencies regarding the sovereign credit risk premium has change and it has been reflected upon the level of CDS on sovereign debt, which has risen for the so-called "vulnerable" countries like Greece, Spain, Ireland, Portugal, and Italy. De Grauwe (2011) considers that the lack of a political committee of the euro area member states for ensuring the financial stability has pushed the default risk towards southern Europe.

Significant decrease in interest rates for the government bonds issued by vulnerable countries (those amended by lowering the sovereign rating) had a negative impact on banks holding such bonds in their portfolio. According to Panetta et al. (2011), the impairing of the banking system in this context has occurred on several channels: the bank's balance sheet channel, the collateral and the liquidity channel, the credit institutions valuation channel and the government guarantees channel.

Banks exposed to the vulnerable countries' government debt were directly hit on the asset side of the balance sheet by reducing the net wealth, increasing the risk event of a disorderly deleveraging that could cause a credit crunch in the banking sector. The increasing of sovereign risk has also reduced the availability of the eligible collaterals and thus harming the ability of banks to get financing in the interbank market and refinancing from the central bank. By changing the ECB's rules regarding the acceptance of collaterals in Eurosystem[73], countries hit by the sovereign debt crisis (Greece, Ireland and Portugal) have been used increasingly the Eurosystem liquidity and also the domestic government bonds and the covered bank bonds to provide assurance for this funding.

[73] For instance, it has been suspended the application of the minimum credit rating eligibility requirement for marketable debt instruments issued or guaranteed by the governments which got international financial support and which had adopted programs for fiscal consolidation negotiated with the European Commission, in liaison with the European Central Bank and the International Monetary Fund (ECB, 2012).

Sovereign downgrade has direct negative effects on the cost of banks' debt and on the market value of the banks, with synchronization between the sovereign CDS premium and banks' CDS premium. Such a relation shows the link between the monetary policy and the sovereign default risk through the banking system.

From the above we note that the uncertainty shock propagated firstly on the financial markets has increased the spread between the interest rates, which have been reflected on the government debt of vulnerable countries, increasing the sovereign default risk. On the other hand, some studies (Ejsing şi Lemke, 2009 or Gerlach, Alexander and Guntram, 2010), assert that the national banking sector vulnerabilities have actually created pressure on the financial markets. The fear of contagion to the real sector has determined governments to implement rescue packages which in turn helped to transfer the risk from the financial sector to the public sector, having repercussion on the sovereign debt.

Weakening sovereign creditworthiness adversely affects the financial stability, the monetary and fiscal policy management, the financial markets and the borrowing costs for the private sector.

In general, for supporting the fiscal adjustments in order to compensate the negative effects of the fiscal policy on the domestic demand, central banks adopt an accommodative ("easy") monetary policy, but it has its constraints given the achieving of the price stability objective and maintaining the central bank independence. In addition to the "classical" risks of a pro-inflationary policy in the euro area (increasing inflationary expectations, building up of an inertial behavior of inflation, lower central bank credibility), there is also the risk of an increasing divergences between countries, given that there are differences between countries in terms of public indebtedness. Thus, countries with stronger economies, lower public debt, and more committed to price stability will not accept a pro-inflationary strategy.

The idea asserted by Bofinger and Soros (2011) that ECB should act as lender of last resort by purchasing unlimited and unconditional debt instruments issued by governments of the euro area in case of market turbulence, is likewise questionable. Such a strategy means that it would be a monetization of the government debt by unlimited money printing. Central banks should act as a lender of last resort, but only if the banks have temporary problems of funding, ensuring short-term liquidity in order to avoid panic.

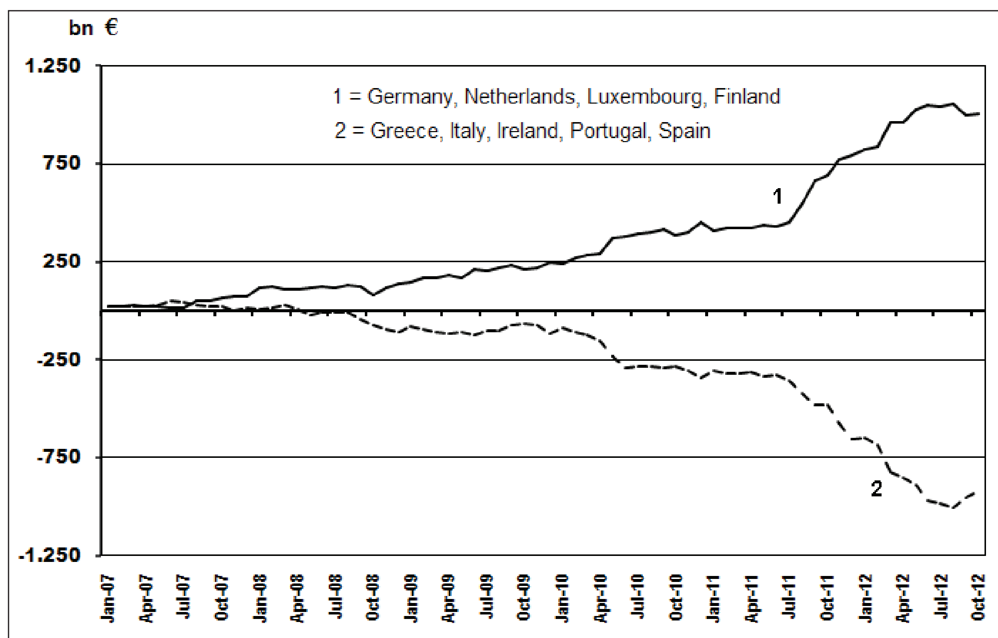
ECB has not been granted with the explicit role of lender of last resort, but the significant deterioration of the conditions for granting loans to eurozone periphery countries has forced the ECB to provide indirect financial support by quasi-fiscal operations to the national governments or to vulnerable countries (see ECB, 2011 and ECB, 2012), in order to limit the contagion between countries. The ECB and the national central banks of the euro system have doubled the overall balance sheets between August 2007 and February 2009, and until summer 2011, when the sovereign debt crisis worsened, they kept their balance sheets relatively steady. In spring 2012, the euro system's balance sheet increased by over 50%, much more than for the other large central banks, as a consequence of the non-standard lending granted to banks under the ECB's long-term refinancing operation program. In summer 2012, ECB has intervened again by backing Outright Monetary Transactions program to purchase unlimited quantities of government bonds of weaker countries.

Through these interventions, the ECB is in a critical situation bearing the risk that on long-term it would lose its reputation as an independent central bank, undermining its fundamental objective of maintaining price stability. It also believes that increasing the ECB interventions in various segments of financial market would encourage the moral hazard for private investors and would crowd out the private

transactions. Thus, the role of ECB refinancing would become more important than the interbank lending.

Besides these risks, the quasi-fiscal operations of the ECB, designed to adjust the problems for the peripheral countries, could bring political tensions between countries, which would increase the market uncertainty regarding the European project's continuity. There are already tensions within the Target 2[74], because it created a significant imbalance in this system between the Northern and Southern Europe; there is an increasing divergence concerning intra-euro area payment balances between Germany, Finland, Luxembourg and the Netherlands, on the one hand, and Greece, Italy, Ireland, Portugal and Spain, on the other hand. As consequence, there has been a notable movement of deposits from Southern to Northern countries, as another trend of flight to quality, like that recorded at the beginning of the crisis, in 2008.

**Figure 1 Net Balance within the Eurosystem Target**




*Source: Date from Euro Crisis Monitor, www.eurocrisismonitor.com, Institute of Empirical Economic Research - Osnabrück University*

The trajectory of Germany's Target 2 balance diverges against the Sothern's Target 2 balances, which means that Germany, the largest AAA country, has the highest level of capital inflows, with a corresponding build-upon of the Bundesbank's claims on the ECB, as their counterparty. Thus, in October 2012, the Bundesbank credit balance reached 720 billion euro, exceeding the total value of bonds issued by governments of the euro area peripheral countries, and purchased by ECB through Securities Market Program.

[74] Target 2 illustrates the relationship between the ECB and national central banks (NCBs). At the euro area level, decisions on monetary policy strategy are taken centrally, but their enforcement and implementation are carried out by national central banks. Each NCB is responsible to provide liquidity to their markets. Payments surplus or deficit on the market created by the system shall be adjusted by Target 2. Thus, the national central banks accumulate debts and liabilities to each other through the ECB and by the "hub and spoke" mechanism. Although Target 2 system these balances are trade-off, the differences are very large, reflecting the imbalances of payments in the euro area.

## AN EXTENSION OF THE SOVEREIGN DEBT CRISIS ISSUE IN THE GEOPOLITICAL FIELD

The European sovereign debt crisis is complex, but it was produced by a single fundamental cause - the formation of the monetary union. Detlef (2012) argues that the current sovereign debt crisis in Europe is not generated by the vulnerabilities recorded in Southern Europe, but the structural weakness. On the one hand, is the way in which the Economic and Monetary Union has been built generates disequilibrium, and on the other hand, are the global economic policy and the "financialization" age imposed by the neo-liberal philosophy over recent decades.

There are two views about the sovereign debt crisis, reflecting a conflict situation between European Union's countries and especially between euro area countries. On the one hand, there is a version supported by the Germany (and the most popular), which considers that Greece entered the risk of default because of the irresponsibility of the government to promote social programs exceeding the available financial resources. On the other hand, there is the version supported by the Greece (and less promoted in the media) according to which Germany, considered the Europe's center of gravity, has designed the European Union and the euro area as tools of economic development in its favor. In this latter version, there is suspicion that the single monetary policy conducted by the ECB would support the German economy, and generally the northern European countries.

The complex effects of the European crisis has caused a crisis of confidence at the regional level - between the Northern and Southern Europe, between the center and the periphery of the euro area, and between the countries from outside the euro area and those from the euro area. Thus, the political crisis has the potential to split Europe, engendering potential geopolitical changes.

The crisis has affected countries outside the euro area through the economic and financial links, at least in the banking system: the subsidiaries of banks from euro area countries which operates in Central and Eastern European countries have sent back the financial capital to their countries of origin for domestic financial problems. Also, some former communist countries are disappointed by the political requirements of the European Union, being forced to implement unpopular substantial institutional reforms in order to become members of European Union. This countries believe that this process was rather costly than favorable for them.

Germany considers that the solution for exiting the sovereign debt crisis is applying a tighter fiscal policy and a strengthening of political euro area by creating a financial transfer union in order to mitigate the trade imbalances, the lack of competitiveness and the problems related to the debt of the weaker countries from the periphery. However, the austerity policies promoted by Germany engendered a deepening recession in European countries, especially in those from the euro area periphery, with negative effects on the long-term. Therefore, the consolidation of the European integration process is questionable.

Political consolidation of the euro area could produce different effects on the economies outside the euro area. The "core" countries of the euro area are focusing on the resolution of their problems and on the way to save the monetary union, but the European countries outside the euro area, particularly those countries from Central Europe become increasingly alienated politically and financially against the European project.

During the financial crisis, some of the ten European Union countries which are not members of the euro area (United Kingdom, Czech Republic, Poland, Hungary, Lithuania, Latvia, Denmark, Sweden, Bulgaria and Romania) have been favored by

their independent monetary policy, being able to maintain an adequate level of country's competitiveness in the regional and international markets, as well as a greater flexibility on the response to the financial crisis. Countries with stronger economies could benefit from maintaining independence from the euro area, but countries which still depend significantly on the financial assistance from the European Union could be affected. For countries that have been less affected by the financial crisis, a deeper integration with the euro area countries is likely to reduce the benefits they have had during the crisis. Some of the new European Union member states (Poland, Czech Republic) have delayed their euro adoption schedule until the financial and political future of the monetary union becomes clearer. Also, countries where the banking sector is well-capitalized and less linked to the euro area financial markets (Sweden, Poland, Czech Republic and United Kingdom) oppose the creation of a pan-European banking regulator. Another fail regarding the political consolidation of the euro area refers to the fiscal compact, which was initially proposed as an European Union treaty, but eventually it was established as an intergovernmental treaty signed by 25 member states (the Czech Republic and the United Kingdom have not signed the treaty). All these differences underlines that the European Union cannot be a political union and trying to force the union in this direction will produce a faster fragmentation on the continent.

Disagreements between countries on the possible fragmentation of the European Union and the euro area shrinkage may generate security problems and potential grouping of countries in the region. Some European countries have already formed regional groups based on economic, political and security concerns. Thus, there is Visegrad group consisting of Poland, Hungary, Czech Republic and Slovakia, there is Wiemar Triangle, an arrangement between Poland, Germany and France in order to strengthen cooperation between them and possibly to create a military force.

The euro area polarization is the beginning of a more complex and broader process on the longer term. It can shape the trend of regional groupings around two major centers: the Scandinavian Peninsula, including developed countries with strong economies, and the Visegrad group. In the first case, it could be attracted countries from the region, like Baltic countries, Poland, and generally countries which, on the one hand, look with distrust at the European Union from the economic and political point of view, and, on the other hand, are concerned about the possible resurgence of Russia, as a Soviet empire. The Visegrad Group in turn could strengthen gradually, enlarging towards northern Balkans, including Romania, Bulgaria and Slovenia.

The development and the consolidation of these regional groups will mark the first significant structural change within the European Union.

## SOME CONCLUDING REMARKS

The persistence of the sovereign debt crisis and the continued political dissensions on the European project highlight that the mere membership of a currency union, with the implementation of a single monetary policy, the ECB monetary policy, is not sufficient to solve the problems caused by the crisis.

The European crisis, by its scope and complexity, has emphasized regional distrust, manifesting tensions between Northern and Southern Europe, between the center and periphery of the euro area, and between countries outside the euro area and those from the euro area. These political tensions have the potential to split Europe, engendering potential geopolitical changes.

The financial crisis that has led to an increasing uncertainty affects not only the European region, but the structure of the big powers (state, corporate or institutional) globally. Paying a greater attention to the domestic issues, the European Union may lose

its position as international political and economic power for the benefit of other (groups of) countries, at a time when there is a general confusion regarding economic and political threats, and some major emergent countries have nothing to lose by resisting the general trend and opening roads to assert its own.

## REFERENCES


1. Bofinger, P. and Soros, G. (2011): *Only way to stop the run on eurozone debt*, Financial Times, 21 November (link: http://www.ft.com/intl/cms/s/0/4f29ab54-1431-11e1-85c7-00144feabdc0.html#axzz2OZwkNNVQ, Date: 10 March 2013)
2. Borgy 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.
3. Criste A. (2012), *Zonele monetare optime*, Sedcom Libris Publishing House, Iaşi.
4. Dabrowski, M. (2010), *The Global Financial Crisis: Lessons for European Integration*, Economic Systems, Vol. 34, Issue 1, pp. 38-54.
5. De Grauwe P. (2011), *The Governance of a Fragile Eurozone*, CEPS Working Document, No. 346, Centre for European Policy Studies, May 2011, Bruxelles.
6. Detlef A. (2012), *Causes of the Sovereign Debt Crisis*, 16 April (link: http://www.e-ir.info/2012/04/16/causes-of-the-sovereign-debt-crisis/, date: 1 September 2012).
7. Ejsing, J. W., Lemke, W. (2009), *The Janus-headed Salvation. Sovereign and bank credit risk premia during 2008-09*, ECB Working Paper, No. 1127.
8. European Central Bank (2012), *ECB Annual Report 2011*, ECB, Frankfurt am Maine.
9. European Central Bank (2011), *Financial integration in Europe*, ECB, May 2011, Frankfurt am Maine.
10. Friedman G. (2011), *Global Economic Downturn: A Crisis of Political Economy*, 9 August (link: http://www.stratfor.com/weekly/20110808-global-economic-downturn-crisis-political-economy, date: 10 February 2013).
11. Friedman G. (2013), *Europe, Unemployment and Instability*, Stratfor Global Intelligence, 5 March (link: http://www.stratfor.com/weekly/europe-unemployment-and-instability, date: 20 March 2013).
12. Gerlach, S., Alexander, S., Guntram, G. B. (2010), *Banking and sovereign risk in the euro area*, Deutsche Bank, Discussion Paper, No. 09/2010.
13. Hannoun H. (2012), *Monetary policy in the crisis: testing the limits of monetary policy*, speech at the 47th SEACEN Governors' Conference, Seoul, Koreea, 13–14 February. Retrieved from www.bis.org/speeches/sp120216.htm. date: January 12 2013.
14. 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 No. 16, April.
15. Panetta F. (coord.) (2011), *The impact of sovereign credit risk on bank funding conditions*, Committee on the Global Financial System, CGFS Publications, No. 43, July.