WHO•S AFRAID OF SOVEREIGN BONDS

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crisis) and with the most recent available data (generally 2011 Q2 or Q3). Some of the countries concerned report longer time series (going back to the early or mid-nineties), and for these countries we also present an historical overview of the evolution of banks• holding, as opposed to non-resident holdings. It has to be stressed that the absence of a single data provider implies that the scope varies somewhat from country to country, for example regarding the type of debt for which the breakdown is available (general government debt versus central government debt, all maturities versus long-term debt, only securities or also loans). We are aware that this may to some extent limit comparability across countries, especially in level terms but we have checked our results against a similar (static) analysis that the International Monetary Fund conducted for Greece, Ireland, Portugal, the UK and the US (IMF, 2011), and found them to be consistent[2]. For European Central Bank holdings

2. The IMF used for those countries the same measure of debt that we use (different across countries) and focused only on the latest available data.

more •EMU-oriented• across the euro area (meaning that the proportion of cross-border security holdings accounted for by Economic and Monetary Union partners increased). Partial evidence suggests that, except for German and French debt, which are traded globally, foreign holders of euro-area government debt are overwhelmingly from euro-area partners[3].

Second, Table 1 also indicates a clear differentiation between continental European and Ireland, the UK and US as far as the size of banks• holdings of sovereign debt is concerned. In 2007, continental banks held significant shares of domestic public debt (more than one-fourth of the total in Germany, Italy and Spain; about one-tenth in France, Greece, the Netherlands and Portugal) whereas in Ireland, the UK and the US, banks held almost no domestic public debt. The vulnerability of the euro area resulting from bank-sovereign interdependence was therefore related to inherited patterns of debt holdings.

The reason why banks in Europe hold so much government debt is possibly twofold. First, it relates to the features of the European financial system, which remains largely bank-based. In continental Europe, banks play a key intermediary role that is to some extent mirrored by the size of their assets. Government bonds are appealing

3. For example in Spain (for which data is available) more than 63 percent of non-residents• holdings in 2005 were accounted for by euro-area investors and more than 80 percent by European investors.

4. More recently, British gilts also experienced inflows, but our data for the UK ends at 2011Q2, so this effect is not evident as November/December figures would be needed.

Consequently, the share of domestic sovereign debt held by domestic banks increased significantly between 2007 and 2011 in all countries with bonds that have been shunned by non-residents (Greece, Ireland, Italy, Portugal and Spain), remained roughly stable in France and the Netherlands, and decreased in Germany. If this can be interpreted as evidence of a new wave of •financial repression• is unclear, but at end-2011, suggestions have been made that banks in the euro area should increase their holdings of government debt (see, for example, President Sarkozy•s public suggestionhis co i]TJ T*0in thlhleg,let.1(eE(e)]9(CB liq als)1uid0368 Tw [(g)140)28.8(et t)23.yNn7.1(t)0y m8.8(-)0

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5.The definition of marketable debt in France is also narrow; see the Appendix.

Figure 2 also shows that the initial phase of the financial crisis has had a much stronger effect on Ireland and the UK than more recent developments. In Ireland the share of non-residents was about to plateau at a very high level at the time of the Lehman shock and dropped immediately by more than ten percentage points. Paradoxically, the very crisis that highlighted the perverse interdependence between banks and sovereigns and its dire consequences for Irish public finances led to a reinforcement of this interdependence. In the UK also there was a shift of the same nature, although of lesser magnitude.

On the whole, our findings reveal common patterns in the changes in the structure of government bond portfolios both in the first nine years and the last three years of EMU. They provide consistent evidence for the recent reversal of tendencies observed across the board during the quiet 1999-2007 period, highlight the reaction of non-resident and domestic banks to concerns about state solvency, and illustrate the safe-haven character of the German Bund.

CONCLUSIONS

The euro crisis has revealed how interdependence between sovereigns and banks can weaken both sides, and the whole monetary union as a consequence. Data presented in this note provides evidence of this hazardous relationship and shows that it has … to some extent paradoxically … strengthened during the crisis.

In 2007, despite a steady diversification trend attributable to the introduction of the euro, most continental euro-area countries were still characterised by the large size of portfolios of their domestic government bonds held by banks. These were markedly larger than in the UK or the US, where banks were not major buyers of government paper. As a consequence, any concern about sovereign solvency was bound to have major consequences for banks.

Developments since 2007 have increased the structural vulnerability of euro-area countries, reinforcing the sovereign/banking crisis vicious cycle. All countries for which(r b)34.2(anks)10anksea

•Developments since 2007 have increased the structural vulnerability of euro-area countries. All countries for which concerns about state solvency arose in recent years have seen a reversal in the previously steady increase of the share of government debt held by non residents.•

an issue that deserves more attention than it is receiving in European policy discussions on how to strengthen the euro area.

REFERENCES

IRELAND (Central Bank of Ireland, CBI): the disaggregation is available only for Irish Long-term Government Bonds and it is impossible to isolate the CBI from other MFIs as holders of government securities in the asset side of CBI’s financial statements.

ITALY (Central Bank of Italy): breakdown available both for general government debt and for securities. We use data for securities because the alternative series includes a break because of reclassification of *Cassa Depositi e Prestiti*.

SPAIN (Banco de Espana): breakdown available for general government securities, from the financial accounts, or for general government debt (Maastricht definition) from the Banco de Espana. We use securities, results are not sensitive to the measure used.

PORTUGAL (Banco de Portugal): breakdown available for general government debt, only annual data.

THE NETHERLANDS (National Statistical Office): data is available for total government debt or for single instruments. We use total securities.

GREECE (Central Bank of Greece): the series for the breakdown of short- and long-term securities by holders can be reconstructed by looking at the liability side of the central government’s balance sheet and merging it with data from the asset side of each sectors’ balance sheet, to fill gaps.

UK (Office for National Statistics, ONS): the breakdown can be reconstructed for long-term government bonds issued by the UK central government, looking at the UK’s sector financial accounts. To isolate the Bank of England we relied on data on the bank’s holding of sterling securities issued by the public sector, provided by the Bank of England itself. For some years, MFIs’ holdings of securities are recorded with a negative sign. This is the result of the accounting practice chosen, as holdings of gilts are reported net of long and short positions.

US (Economic Report to the President and Treasury Monthly Bulletin for the most recent months’ data, older data is identical across the two sources): the breakdown is available for Treasury Securities. To isolate the Federal Reserve, we use data on the consolidated statement of conditions of all Federal Reserve Banks, which identify Treasury securities holdings on the asset side. Pension funds are divided between private and government funds. We decided to combine government pension funds and private sector funds, but the weight of this category is very limited in any case.