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How are exposures to periphery evolving?

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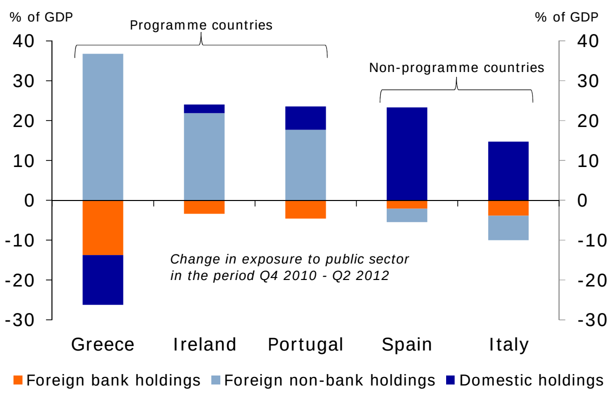
Domestic residents of the eurozone periphery countries have increased their exposure to their respective governments as foreigners headed for the exit. This is an unwelcome development since it further reinforces the pernicious link between weak sovereigns and weak banks.

Figure 1: Governments rely on domestic residents



Source: JEDH, BIS, Reuters EcoWin

The amount of exposure to the public sectors of the hard-hit eurozone periphery countries has become a subject of great interest amongst market participants. As a general rule in the financial markets, the less a country or institution is exposed to the public sectors in Greece, Ireland, Portugal, Spain and Italy, the less vulnerable it is perceived to be to the contagious effects of the euro crisis. Consequently, BIS-reporting banks (from 24 countries) have reduced their exposure to these countries in the period 10Q4-12Q2 (figure 1). The enormous drop in the case of Greece is a result of the Private Sector Involvement (PSI) whereby banks faced a large haircut on their Greek sovereign bond holdings. At the same time, figure 1 shows that foreign non-bank holdings of public debt in Greece, Ireland and Portugal rose (as a share of GDP) due to the bailout packages offered by the 'troika' (ECB, IMF, and EU) while that of Spain and Italy dropped.

What is particularly interesting is that, with the exception of Greece, domestic residents have increased their exposure to sovereign debt of their respective countries. The increase is extremely significant in the case of the non-programme countries. The question is why is it that as foreigners headed for the exit, the domestic residents stepped in to purchase sovereign debt (or at least maintain their position)? The answer provided most often is that foreigners are relatively more 'foot-loose' because they suffer from asymmetric information problems. In other words, they have less knowledge about a country's 'true' macro fundamentals vis-à-vis their domestic counterparts. An alternative explanation is that domestic residents, especially banks, are facing financial repression, which are subtle policies adopted by governments to channel to themselves funds that in a deregulated market environment would go elsewhere. These include directed lending to the government by captive domestic audiences (such as pension funds or domestic banks), regulation of cross-border capital movements, and generally a tighter connection between government and banks, either explicitly through public ownership of some of the banks or through heavy 'moral suasion'. Thus, through financial repression, governments can keep interest rates lower than they would be in more competitive markets. Of course, banks may have also increased their exposure without any 'force' in order to avert a very costly sovereign default that could deplete their own capital buffers.

Regardless of the reason behind this development, the rise in exposure of domestic residents to their sovereigns reinforces the pernicious link between the two and recent history has shown that this is not a welcome development. Banks that are joined at the hip to their respective governments are very much exposed to sudden repricing of sovereign risk. We maintain the view that the introduction of banking union and eurobonds would address the undesirable fiscal-financial nexus in the periphery.

How are exposures to periphery evolving?

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