

Example of essay on international financial markets

[Business](#), [Marketing](#)



Impact of sovereign debt on the performance of international equity markets

Introduction

This essay analyses how sovereign debt problems initially faced by a few relatively small economies could trigger a wide impact on financial markets.

The impact of the spill-over effect of sovereign debt is examined by using Greece as an example, whose economic GDP is only about 2% of the Euro Zone economy but its debt crisis has had a damaging impact on the financial markets across Europe and other parts of the world as well.

The essay specifically examines the international performance of the bond market, thus analysing the extent to which the poor bond performance of one country can affect investors' behaviour towards the bonds of other countries that share similar characteristics.

The bond market

There are three main variables that influence the performance of the bond market: risk, expected rate of return and liquidity. Like in any investment, the higher the risk, the higher the expected rate of return is. The market will respond to higher risks through increased higher bond yields. When dealing with government bonds, credit risk increases if the fundamental macroeconomic factors are weak and the market experts forecast low growth.

Sovereign debt crisis

Following the global economic crisis, many governments relied on bond markets to raise the required finance from the private sector especially

pension fund companies, insurance companies and banks in order to finance government operations.

The deeper the deficit problem is for countries, the more bonds they sell. Until the recent sovereign debt crisis, governments have not been known to default and so government bonds have been generally considered risk-free by investors. By leading a proper monetary and fiscal policy governments are expected to improve their economic performance and be able to raise revenue in order to meet interest obligations in the short-term and pay off the original debt on maturity.

The impact of the financial crisis has seen widened governments' deficits, increasing expenditure on social welfare, while collecting lower levels of income. Greece has been the epitome of the crisis. In her report on "The Spread of European Sovereign Debt Crisis, April 2012", Lia Mendez explained that "Greece continued to enjoy access to EU and International funds at low interest rates because the Eurozone member countries were considered financially and politically stable, regardless of their actual, individual financial circumstances". However, as indicated in the Lia Mendez's report, following the crisis, Greece's "economy and growth decreased by 2% of GDP, exposing weak fiscal policies that the country had been pursuing for years". Greece's debt position could no longer be hidden.

Coupled with recessions and the "highest levels of debt in the EU at 126.8% of GDP from 2009" (Lia Mendez, April 2012, "The spread of the European Sovereign Debt"), it was clear that Greece could not meet its interest and debt obligations as they matured. Default was imminent.

Impact on investors in the bond market

Just like any other financial markets, the increased risk of default created panic and bondholder reaction to minimise risks. In the report on “ What is the European Debt Crisis”, Thomas Kenny (May 2012) writes that investors responded by demanding higher yields on Greece’s bonds, which raised the cost of the country’s debt burden and necessitated a series of bailouts by the European Union and the ECB.

Panic in the financial market was created not primarily because of the exposures that investors had in Greece, as its economy is far less compared to the regional economy. The panic was caused by the fear that the Greek situation could be replicated by larger economies like Italy, Portugal and Spain which shared similar characteristics with Greece like high debts levels but low income levels. The investors in the market were concerned about the effect of contagion.

“ Contagion refers to the spread of market disturbances - mostly on the downside - from one country to the other, a process observed through co movements in exchange rates, stock prices, sovereign spreads, and capital flow” [Rudiger Dornbusch, Yung Chul Park, and Stijn Claessens (August 2000), The World Bank Research Observer, vol 15, no2].

In his key note address on “ Bank Competitiveness in the Post-crisis World” (10 October 2011), at the Bocconi University (Milan, Italy), Victor Constancio (Vice President of the ECB), outlined “ two underlying ideas” to contagion; “ that the spread would usually not happen without the initial shock and that the transmission of the initial instability goes beyond what could be expected from the normal relationship between markets or intermediaries, for

example in terms of speed, strength and scope”

The main cause of contagion is “ the normal interdependence among market economies, thus the shocks can be transmitted across countries because of their real and financial linkages. The second reason is “ not linked to observed changes in macroeconomic or other fundamentals but is solely the result of the behaviour of investors or other agents.” (Rudiger Dornbusch, Yung Chul Park, and Stijn Claessens, August 2000).

According to the same report, the degree of financial market integration will influence the extent of the spread of the crisis. This shows that for contagion to take place, there must be linkages in the financial system and that there must be an initial shock.

In March 2012, there was a renegotiated deal for Greek bond investors and as reported in the Telegraph Newspaper by John Burn-Murdoch and Conrad Quilty-Harper (6 March 2012), there was a swap offer for new bonds with later maturity dates and lower returns, allowing the Greek government to write off €100 billion of its debt. According to the report, the French private sector held more of the Greek bonds with BNP Paribas “ writing down 75% of its Greek bonds; and that the British and German investors stood to make big losses as the second and third largest holders of Greek bonds”.

With investors facing losses in Greece, on 5th July, 2011, Moody downgraded Portugal’s credit rating to junk territory (by four levels to Ba2) on the premise that it “ would not be able to meet debt stabilisation targets”. The “ downgrading of Portugal and continuing fears of a Greek default apparently triggered a sell-off in Spanish and Italian government bonds” (Victor Constancio, October, 2011). Within a few days, the Italian government bond

yields increased by almost 100 basis points, while Spanish ones had increased by more than 80 basis points (Victor Constancio, October, 2011). This signifies increased credit risks in the debt.

“ When one country is hit by a shock, liquidity constraints can force investors to withdraw funds from other countries trade links, regional patterns and macroeconomic similarities make countries vulnerable to volatility” (Rudiger Dornbusch, Yung Chul Park, and Stijn Claessens, August 2000).

The chart below shows the bond yield in the Euro during its introduction, Lehman’s Collapse and sovereign debt crisis.

Spain, Portugal, Ireland and Greece have the highest yields because of increased risk.

The problems in the bond market can have far-reaching consequences in the entire financial market. According to the Guraziu, “ Firstly, if a country defaults, banks are likely to face severe problems, particularly in the country where default occurs, but also in other countries, especially Europe, given their links through a monetary union; secondly, cross-border institutions operating in a variety of countries and holding a variety of sovereign debt are a potential source of propaganda of sovereign default across countries” (Sovereign debt crisis and its impact on world markets).

Discussion

The brief summary of findings above on the performance of the bond market indicates that in the modern globalised financial system, shocks in the financial market of one nation can lead to shocks in a wide financial market. When referring to investments in bonds, the aim is to maximise returns while

minimising risk. Generally government bonds have been considered safe haven for investors because of low risk and unsurprisingly lower returns than the equity investment. Clearly, the fundamental assumption has been that governments would not default, but would use their macroeconomic policies to improve economic growth and raise the revenue to meet interest payments and settle debts as they fall due.

The economic crisis has proved that with basic fundamental macroeconomic not working, the risk on bonds increases and as a result the yields increase resulting in increased cost of borrowing. The increased credit risk increases the potential for default creating panic in the market. This leads to the changed market perception when government bonds are in question.

With the integration of the financial system, governments raise finance from both domestic and mostly international investors. This spreads the risk of financial loss across the nations. For example, as reported in the Telegraph Newspaper (6 March, 2012), the biggest private investors in Greece were from France, Britain and Germany. The report in the USA Today indicates that the American investors were also substantially exposed to the Greek and Euro zone financial crisis and that they were scaling down investing in the region.

Therefore, the effect of the deteriorating bond market in Greece affected the financial position of the bondholders in other countries. As investors wrote down part of their exposure in Greece, financial experts predicted liquidity problems for the larger economies of Spain, Italy and Portugal which faced similar macroeconomic failures of heavy reliance on credit markets, recession, high unemployment, high bond yield and downgrading of their

credit ratings as Greece and that they would need bailout. The result was the rise in the bond yields in Spain, Italy and Portugal.

As Italy and Spain are the third and fourth biggest economies in Europe, the investors in their bonds are global and therefore the failure of these markets would have global financial collapse as was the case with the global financial meltdown following the collapse of Lehman Brothers. International institutions holding bonds in these nations are also a source of speculation and could see their equity values declining.

While the focus has been on the bond market, it is just a small element of the wider financial markets which include equity markets, money markets, derivative markets, foreign exchange markets, etc. All of these markets are interconnected and the spread of the shocks of the bond market to other nations affects the wider financial markets. This arises as a result of liquidity problems in the financial system as investors reduce their level of investments.

As it is the case with all financial markets, the performance of the bond market is based on speculation. Negative speculation on any country increases the risk profile of that country and therefore gives rise to bond yields to compensate for increased risk. The risk of default signifies failure of basic macroeconomic policies of a country and leads to sovereign debt crisis.

With the integration of the financial markets, speculation of default by one country affects market performance in other countries because the risk of systemic market failure. Banks and other financial institution from other

nations that hold the sovereign debt suffer financial loss and so investors react to minimise the risks.

With monetary union in Europe, the effect of the failure by one market is severe because there is unitary monetary policy which is not backed by mandatory unitary fiscal policies. The increased risk in the region brings along increased risk at global level because of the linkages with other financial markets. This was the reason for the spread of the global economic crisis which would have otherwise affected USA only.

Eyes are still on Greece and that if it defaults; it could define the future of the Euro zone. It is therefore clear that the government debt problems of a small nation like Greece could just be a spark that ignites markets as all are linked and substantially dependent internationally.

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