Available online at www.sciencedirect.com
SciVerse ScienceDirect
Procedia Economics and Finance 3 (2012) 763 – 768
Procedia
Economics and Finance
www.elsevier.com/locate/procedia

Emerging Markets Queries in Finance and Business

The Euro area sovereign debt crisis and the role of ECB's monetary policy

Angela Roman[a,*], Irina Bilan[a]

[a] "Al. I. Cuza" University of Iasi, Bd. Carol I no. 11, Iasi 700505, Romania

Abstract

Against the background of the economic and financial crisis, public finances severely deteriorated in many EMU Member States and a new crisis, of sovereign debt, emerged. Considering ECB's recognized responsibility for ensuring overall financial stability, our paper shortly overviews the main monetary policy measures it adopted since May 2010, proving the vital roleof ECB's interventionin countering the effects of the sovereigndebt crisis. The added value of our work mainly results from the coherent analysis of the interconnections between sovereign crisis, banking crisis and the real sector of the economy, as determinants for ECB's intervention, as well as from highlighting the potential risks entailed by ECB's actions over the medium and long term.

*Keywords:*sovereign debt crisis; banking sector crisis; financial stability; monetary policy; European Central Bank;

1. Introduction

The economic and financial crisis had major negative effects on EMU Member States' public finances. The measures undertaken by national authorities to rescue financial institutions in trouble, together with the cyclical effects of the economic downturn on public revenues and expenditures and the discretionary fiscal stimulus measures led, in many countries, to significant budget balance deterioration and increasing public debt over the sustainable level. In some countries, like Greece or Italy, this added to some already existing budgetary

*Corresponding author. Tel.: +40-232-201-440; fax: +40-232-201-433.
E-mail address: aboariu@uaic.ro.

2212-6716 © 2012 The Authors. Published by Elsevier Ltd.
Selection and peer review under responsibility of Emerging Markets Queries in Finance and Business local organization.
doi:10.1016/S2212-5671(12)00227-4

vulnerabilities, reflected in high budget deficits and public debt prior to the crisis. Thus, to the initial financial and economic crisis, which seemed to be overpassed at a time, followed a new, sovereign debt crisis, perhaps with even more serious effects on the Euro area financial and macroeconomic stability.

Against the new economic and financial background, debates intensified within the academic and banking community on defining the role that ECB should have in supporting for fiscal consolidation, also taking into account its main objective of ensuring and maintaining price stability in EMU, as well as the potential existence of conflicts between the two paths. In fact, it was generally admitted the need for ECB to intervene, provided that its fundamental objective is not jeopardized over the medium and long term.

Our work follows three main directions. The first part deals with the methodological issues and offers a short review of existing literature, in order to highlight the place of our research. The second part of the study aims to highlight the interconnections between governmentdebt and banking sector crises, pointing out the risks for the manifestation of a systemic crisis in the euro area and arguing for the necessity of ECB's intervention. The last part of the paper reviews the measures adopted by ECB in order to limit the impact of the sovereign debt crisis on the banking sector and thus on the supply of credit to companies and households, but also the potential risks entailed by these measures, over the medium and long term.

2. Objectives of the research, methodology and state of knowledge

Our paper seeks to answer two questions:

- what is the connection between sovereign debt crisis and banking sector disruptions why should monetary authorities take action to solve public debt crisis?
- how did ECB react to the recent Eurozone sovereign debt crisis and what are the potential risks entailed by such reactions?

The study is primarily conceived as a theoretical approach, supported by the analysis of relevant statistical indicators on public finance and banking. As statistical data sources we used databases and reports of ECB, Eurostat and national central banks, as well as some published studies relevant for our research.

Topical issues of present times, the sovereign debt crisis and its manifestation in some developed countries, mainly from the European Union represented, especially since 2010, when Greece first showed to be in financial distress, the subject of numerous theoretical or empirical studies. They mainly focused onthe causes and development of thecrisisas well as on the potential/effectively adopted policies by supranational/European or national authorities to cope with its effects, as shows Cline, 2011;Cafiso, 2012;Blundell-Wignall, 2011;Shambaugh, 2012;Costancio, 2012.

Based on the experience of previous crises, the literature points outthe existence of a close interdependence between the manifestation of sovereign debt and banking crisis. The studies undertaken by C.M. Reinhart and K.S. Rogoff, 2008 and 2009 show that previous banking crisis episodes were often accompanied by dramatic increases in public debt, not only as a result ofpublic authorities' interventions to bailout banks in distress, but especially due to the drastic contraction of GDP and the drop of tax revenues.

At the same time, a reversed relationship is not to be excluded, public debt crises entailing potential risks for the banking sector. This connection is frequently invoked in the context of the currentEurozone public debt crisis, evidenced by the correlated evolution of bank and sovereign CDS, as evidenced in Blundell-Wignall, 2011; Alter and Schuler, 2011;Angeloni and Wolff, 2012;Caruana and Avdjiev, 2012 and Shambaugh, 2012. The transmission mechanisms outlined in the literature are diverse and often ambiguous, mainly referring to: the lower value of bank assets due to their holdings of overindebted countries' public debt,whose market value decreases; the decreasingvalue of the guarantees that can be used for refinancing;the transmission of sovereign downgrades on the credit ratings of banks originating from that country; the smaller amount of implicit/explicit warranties granted to banks by governments in distress, as evidenced in BIS, 2011;Angeloni and Wolff, 2012;MerlerPisany-Ferry, 2012. Also, as Bolton and Jeanne, 2011show, in highly financially integrated