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EDHEC-Risk Institute Considers that Germany's Restrictive Measures on the Sovereign Debt Markets are Counterproductive, Inconsistent and Liable to Hinder European Growth

On the basis of numerous academic studies, along with its own research, including the position paper published in March 2010 by Professor Abraham Lioui entitled "Spillover Effects of Counter-cyclical Market Regulation: Evidence from the 2008 Ban on Short Sales," EDHEC-Risk Institute considers that the unilateral measures taken by Chancellor Merkel on the sovereign debt markets, both on the short selling of sovereign bonds and credit default swaps (CDS), are counterproductive, inconsistent and liable to hinder European growth.

Counterproductive

Besides the fact that the lack of convergence on these issues with the US authorities leaves little hope of the measures being effective, EDHEC-Risk Institute thinks that this ban poses numerous problems and runs up against legal and practical obstacles that make it inapplicable or even counterproductive:

- It will be impossible for intermediaries and ultimately for regulators to verify investors' holdings of the securities representative of the risk the credit default swaps are assumed to cover.
- A strict obligation to use credit default swaps to hedge the risk of sovereign debt would prevent sovereign nations from issuing long-term debt, as the CDS market for hedges of more than ten years is relatively illiquid.
- This prohibition makes it harder for countries to manage the interest rate risk on their debt actively, as their counterparties are no longer able to hedge the country risk of the interest rate swaps they may have entered into. This active management of the yield curve is a major component in the optimisation of the cost of public debt.
- By making the market for hedging default risk more complex, the markets may be deprived of the debt of countries with low ratings, of investors, and thus of liquidity, which will inevitably increase the cost of this debt.

Inconsistent

Even while European Commissioner Michel Barnier, in a letter to Professor Noël Amenc, Director of EDHEC-Risk Institute, on May 5, 2010, was confirming that "a group of experts from the Commission has been given the mission of studying the effects of CDS on price formation and the liquidity of the underlying bond market," Chancellor Merkel's unilateral decision, which renders the functioning of the sovereign debt markets responsible for the euro's difficulties and the increase in the cost of credit for certain European countries, is inconsistent.

Once again, financial regulation decisions have been based more on preconceived ideas and populist posturing than on objective analysis of the facts. From that viewpoint, the position of the president of the European Commission who, without concerning himself with the work instigated on the subject by Commissioner Barnier, supports Germany's reasoning, appears relatively incompatible with the requisite solidarity of the Commission and the consistency of European policy.

A hindrance to growth

A very strict definition of a naked sale would keep investors who finance public investment or companies that enter into contracts with sovereign nations or with state-owned companies from hedging the default risk of their counterparties. At a time when public-private partnerships and private financing of public infrastructure projects are considered one of the drivers of global growth, making it harder to manage country risk may, at the very least, increase the costs of these partnerships and this financing and, at worst, prove a major hurdle to their development.

This limitation on the hedging of risk for companies exporting capital goods, engaged in major international contracts with the public sector, and for the credit institutions that finance them, is of a nature, if it is generalised, to slow down or render more difficult the exports of a large number of countries within the European Union.

The following elements can be accessed by pressing [Ctrl] and clicking on the link:

Open letter addressed by EDHEC-Risk Institute to European Internal Market Commissioner Michel Barnier on March 15, 2010:

http://docs.edhec-risk.com/mrk/000000/Press/ERI_Letter_Barnier_150310.pdf

Commissioner Barnier's response on May 5, 2010 (in French):

http://docs.edhec-risk.com/mrk/000000/Press/Barnier_Response_ERI_050510.pdf

EDHEC-Risk Institute Position Paper "Spillover Effects of Counter-cyclical Market Regulation: Evidence from the 2008 Ban on Short Sales," March 2010:

http://docs.edhec-risk.com/mrk/000000/Press/EDHEC_Position_Paper_Short_Sale_Ban.pdf

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About EDHEC-Risk Institute

EDHEC-Risk Institute is part of EDHEC Business School, one of Europe's leading business schools and a member of the select group of academic institutions worldwide to have earned the triple crown of international accreditations (AACSB, EQUIS, Association of MBAs). Established in 2001, EDHEC-Risk Institute has become the premier European centre for financial research and its applications to the industry. In partnership with large financial institutions, its team of 47 permanent professors, engineers and support staff implements six research programmes and ten research chairs focusing on asset allocation and risk management in the traditional and alternative investment universes. The results of the research programmes and chairs are disseminated through the three EDHEC Risk Institute locations in London, Nice and Singapore.

EDHEC-Risk Institute validates the academic quality of its output through publications in leading scholarly journals, implements a multifaceted communications policy to inform investors and asset managers on state-of-the-art concepts and techniques, and forms business partnerships to launch innovative products. Its executive education arm helps professionals to upgrade their skills with advanced risk and investment management seminars and degree courses, including the EDHEC Risk Institute PhD in Finance and the EDHEC Risk Institute Executive MSc in Risk and Investment Management.

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