

# Robust Financial Markets – Something to Bank On

Greece, Ireland and Portugal avoided bankruptcy only due to a bailout by the European Union and the International Monetary Fund. The stability of the European Monetary Union hangs in the balance. Since the onset of the crisis, experts have debated new sanctions, the establishment of a monetary fund and other institutional possibilities. Yet it is not the rules that are at fault, our author believes, but a failure to apply them properly. Thus his call for more trenchant reforms of the banking sector and financial markets.

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**T**he European Union has changed with historically unprecedented speed in the last 18 months. Back in fall 2009, who would have thought it possible that, 18 months later, three EU member states – Greece, Ireland and Portugal – would succumb to a debt crisis so extreme that only hundreds of billions of euros in guarantees would save them from insolvency? Who

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## The focus of attention is shifting to the role of creditors

would have thought that, in the space of one weekend, the European Union, in concert with the International Monetary Fund, would agree to spread a 750 billion euro safety net for insolvent members, blatantly ignoring Article 125 of the treaty that defines how the European Union should function? Who would have thought that the European Central Bank would ever become a bulk buyer of dubious sovereign debt, then promptly move to increase its subscribed capital?

Europe's political reactions, too, were something to behold. On September 7, 2010, the Council of Ministers discussed the introduction of the "European Semester," to commence in 2011. The Semester, which begins in March each year, is essentially a cycle of consultation in which member states are required to submit their national budgets for the following year for discussion at the European level – with the participation of the Commission and the Council. At a summit on September 29, 2010, the European Commission then presented plans for a wide-ranging reform of the European Union's financial constitution. The Commission proposed to tighten the supervisory and disciplinary measures of the Stability and Growth Pact and make potential sanctions against debtor states a more automated consequence. It also created an entirely new system of supervision, intervention and sanction, the function of which would be to diagnose, deter or punish possible macroeconomic imbalances within individual member states. In May 2011, the Council of the European Union made the decision to expand the safety net by additional hundreds of billions of euros, and to perpetuate this safety net and rename it the European Stability Mechanism (ESM). Some observers already consider the ESM to be the precursor to

<sup>1</sup>This article is largely based on ideas outlined in "Schulden ohne Sühne? Warum der Absturz der Staatsfinanzen uns alle trifft," a book by Kai Konrad and Holger Zschäpitz that was completed in May 2010. The article is a modified version of a contribution that appeared in WIRTSCHAFTSDIENST (Vol. 90(12), 2010).



European government bonds. Simultaneously, it was decided to reform the treaty, making the euro and its survival a European policy goal. This treaty reform can be seen as a major change in European governance, as it potentially opens the door for many future policy measures.

Apart from these far-reaching resolutions, there are myriad other considerations occupying the political space. How are these initiatives to be assessed in light of the past ten years of experience with the European Stability and Growth Pact? Can these resolutions overcome the central problems of credibility that have, in the past years – but especially in 2010 – prevented important pages of the rule book from being applied? And if the answer to these questions is clearly no, what would the correct political response be?

Many observers blame the failure of the Stability and Growth Pact on an absence of transparency and a lack of political appetite to implement the rules of the Pact. Thus their call for the rules to be reformed: more transparency and more prevention will, they hope, facilitate prompt reactions to possible fiscal misdemeanors. Existing political voting mechanisms, it is argued, should be replaced by rigid rules and the automated imposition of sanctions on those who

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## There are many calls for the rules to be reformed with more transparency and more prevention

break them. Preventive monitoring of individual budgets (the European Semester) is intended to allow early intervention before the (mis)deed is done – and long before an imbalance occurs. More transparency and prevention would have revealed Greece's financial plight at an earlier stage. It would then have been possible, so the argument goes, to put Greece back on a sustainable financial course.

Automated mechanisms in place of political majority decisions are justified by the argument that, in the past, "one culprit has been voting on sanctions against another." In that position, there was insufficient incentive for sanctions to be imposed. The result would actually have been to compound

the fiscal wrongdoing, insofar as culprits running up excessive deficits would be confident that there would be no political majority in favor of punishment. Automated mechanisms would not suffer from this credibility problem.

There may be a kernel of truth in these arguments. However, one cannot hope to render the Stability and Growth Pact both credible and functional by these measures. It was not fundamentally an absence of information about just how unsustainable the budgetary policies pursued by individual member states actually were that led to Europe's sovereign debt crisis.

Even according to the official statistics – which have themselves lately been strongly criticized – Greece exceeded the 3 percent threshold for net government borrowing in nine out of ten years since it joined the euro zone. These infringements were not a state secret. The situation may have been made worse by the financial and economic crisis, but it had been developing in plain sight over many years.

Even under the kind of supervision envisaged by the European Semester that has now been adopted, states can appear to be treading a path of financial sustainability while still heading deeper and deeper into debt. A government that is resolved to continue to run up debt, and that has the support of broad sections of its own population in doing so, will still have the means despite the European Semester. There are few limits when it comes to dressing up the balance sheet.

Selling public buildings at high prices, then leasing them back at excessive rents, or taking out loans via public undertakings that are themselves backed by state guarantees are just two examples of a whole class of concealed arrangements by which a government can take on additional debt that bypasses the official budget. And this kind of debt is generally more expensive than openly declared government borrowing.

Given these possibilities, even a far more comprehensive and penetrating system of monitoring national budgets than the one enacted by the EU would have little chance of success. It would, however, have an unwelcome side effect: if, despite intense supervision and restrictions on individual autonomy, a member state were to find itself in dire budgetary straits, the debtor would have good reason to demand that the European community come to its aid: as long as the debtor is only doing what





the other states demand, and its actions are subject to strict rules, provided that it is in formal compliance, the others cannot very well claim that it alone is responsible for its actions. The example of Ireland's impending insolvency in November 2010 showed that adequate transparency in matters of budgetary policy is not sufficient to avoid extreme imbalances. Ireland's deficit was not especially conspicuous. It was rather the case that the country came to grief as a result of the guarantees it gave for the Irish banking sector – a measure that would not necessarily have fallen foul of a system of prevention, or attracted automatic sanctions.

So what can one expect of automated sanctions? Can it be hoped that such sanctions will constitute a credible threat of punishment for fiscal misdeeds, and as such, have a disciplinary effect on individual states? Or will automated mechanisms ultimately fail to act as a credible deterrent?

In fact, the experience of the past ten years already hints at an answer to the questions. The Stability Pact, in its pre-reform version, already provided for a range of automated mechanisms that were later deactivated. Consider the intervention by the German government in 2002, which initially prevented the implementation of an entirely automated delinquency procedure. A more dramatic and more important example of the failure of automatic rules is that of the safety net installed in May 2010: the “no-bailout clause” in Article 125 was fundamentally conceived as an automated mechanism.

The rule states that if a euro zone member state should find itself in extreme fiscal difficulties, neither the community of states nor any individual member state is required to provide financial assistance. Publicly and politically, the rule has predominantly been interpreted as “shall not provide assistance.” However, this automatic no-bailout mechanism did not prevent the euro states from flouting the rule book.

There has been broad speculation as to why, in May 2010, the European Union and the International Monetary Fund spread out a 750 billion euro safety net as a mechanism for inter-state assistance. At any rate, large parts of the political community were concerned that, following Greece, other euro zone countries, too, would soon find themselves in a situation in which it was practically impossible to re-finance their borrowings on the capital markets. By putting this rescue plan in place, the politicians hoped to avoid this chain of events. Above all, how-

ever, there was widespread fear that, if one or more of these states were forced to restructure their debt, the result would be to throw the financial markets into disarray and trigger insolvencies among major financial institutions of systemic importance.

Given the possible negative consequences, Europe found itself in what is known as the “Samaritan's dilemma.” As applied to the relationship between the euro states, the situation was essentially as follows: while there was no deep bond of attach-

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## The European Stability Pact already provided for a range of automated mechanisms

ment or altruism between these states, it was in the interests of the richer among them to assist those on the periphery in order to avert the consequences that such a debt restructuring would have on their own banking sectors.

The expectations of assistance, including the possibility of long-term inter-state transfer payments, proved to be a harmful incentive both among the states and on the government bond markets, insofar as they implied joint liability on the part of the euro zone countries. Holger Zschäpitz and I described the consequences in our book *Schulden ohne Sühne?* In such a situation of shared liability, states have too little incentive to save and consolidate – something that also applies even to states that are repeatedly seen as riding to the rescue. One of the few credible ways for such states to cast off the mantle of rescuer is to run up high levels of debt of their own.

What's more, the buyers of government bonds cease to have any incentive to verify the creditworthiness of individual countries and to respond to any deterioration by exhibiting a reluctance to buy. If they are going to get their money back come what may, there is no need for them to distinguish between lending to states of sound or unsound financial standing. Consequently, if a member of the community of states over-borrows, it impacts the creditworthiness of the community as a whole. Refinancing costs rise for every member of the community. >



In fact, the costs borne by one small member state are only a fraction of the added expense caused by its own over-indebtedness. The bulk of the burden is shouldered by the other states. This, too, can lead to fundamentally excessive borrowing on the part of every individual state.

The political effects of this Samaritan's dilemma for "Project Europe" may prove to be more significant than even the impact on bond markets and on the budgetary policies of member states. Repeated

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## Repeated aid payments lead to tensions

aid payments or extensive transfers from richer to poorer members that could well extend over many years and assume substantial proportions are likely, in the long term, to lead to political tensions between donors and recipients.

The rescue package for Greece has already given us a foretaste. In Germany, for example, the Greeks were frequently branded as lazy tax dodgers. The perception that Germans were expected to tighten their belts in order to send money to Greece was not especially popular. The discussion was dominated by news reports citing uses to which the money would be better put in Germany rather than sending it to Greece. At the same time, voices were raised in Greece calling for Germany to make reparations for World War II, even if no official demands were forthcoming.

The potential for such a situation to blow the European Union apart is considerable. There are signs of a dividing line being drawn in Europe between those states with sound finances and those whose financial position is less sound. In view of Europe's history, it is unlikely that Germany will take the first step toward abandoning monetary union. It is, however, conceivable that some states will draw their own conclusions.

In addition to the international tensions that might develop as a result of inter-state transfers, a European Transfer Union would also have the potential to ignite radicalism in individual countries. Slogans such as "Saving for Greece? No thanks!" could inspire populist movements on both ends of

the political spectrum. Were radical populists to accede to government responsibility on the back of this issue, the result could be to trigger potential splits within the European Union.

So what is the right thing to do? How do we extricate ourselves from this dilemma? The Advisory Committee to the German Federal Ministry of Finance outlined an answer in a letter to the Minister in the summer of 2010. The Committee advised that Europe's financial constitution should be left untouched. With an independent Central Bank, a procedure for budgetary supervision (Article 126) and, above all, the no-bailout clause in Article 125, there are already excellent rules in place. If they were to be complied with, these rules would be adequate to ensure price stability and sustainable budget policies. It is not the existing rules that are at fault, but failings in their application.

The fact that the no-bailout clause was set aside by political resolutions has less to do with the rules themselves than with the institutional context in which decisions are made on how to apply them. Therefore, when it comes to reform, the central question is: Which factors in the institutional environment were principally responsible for deactivating the automated no-bailout mechanism? We must then ask how these factors can be altered.

One of the central reasons for not applying Article 125 and proceeding instead with a financial rescue, first for Greece and later for Ireland and Portugal, is the state of the financial markets: as long as politicians fear the market turbulence and bank-

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## The financial constitution should be left untouched

ing sector insolvencies that restructuring the debt of a euro zone country would entail, no restructuring will take place – even if it were the economically correct and necessary thing to do. If the no-bailout clause is to be upheld in the future, then rather than reform the Stability and Growth Pact, the true reasons for why the no-bailout clause was overruled need to be addressed. This implies more trenchant reforms of the banking sector and the financial markets.

Debt restructuring means putting a partial block on the repayment of sovereign debt, followed by negotiations between government and creditors regarding the terms of repayment. This is by no means a pleasant event for the financial markets, given that the holders of government bonds will forfeit some of what they are owed. (A clear distinction should be drawn between debt restructuring and an exit from the euro zone: the one does not entail the other, even though, unfortunately, the two are often confused in the economic policy debate.)

An adequately robust banking system that is properly provided with equity, and in which banks do not build large unbalanced positions in the bonds issued by any one individual state, but instead divide their investments between a balanced variety of asset classes, can survive the write-offs resulting from restructuring the debt of a euro zone country relatively unscathed. Banks with a sufficiently conservative investment strategy can accommodate such write-offs without getting into difficulties themselves.

To imagine banks and financial markets in such a robust state is not utopia. On the contrary, this is a situation in fundamentally stable balance: in a financial world in which all banks and financial institutions are well provided with equity and pursue a conservative investment strategy, there needn't be an incentive for any individual among them to deviate from such a strategy. One or another might attempt to build huge and risky positions, betting on a specific event, as may even be common practice in the current financial market situation.

In view of the behavior of the other banks and their equity capital, however, this would be a dangerous course of action for both the institution and its shareholders. Given the robustness of every other bank, the transgressor that over-reached itself would simply go under. Unlike the present situation, the government would have no need to launch a rescue since, in a sufficiently resilient financial world, the individual bank would not be a systemic risk.

Robust financial markets with banks whose shareholders bear responsibility for possible investment losses and that are not in need of being saved at any cost are desirable for many other reasons, too. A sufficiently strong financial market system might even save the world from future financial crises and their attendant impact on the economy.



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#### THE BOOK

Kai A. Konrad / Holger Zschäpitz, **Schulden ohne Sühne?** *Warum der Absturz der Staatsfinanzen uns alle trifft* [Debt without atonement? Why the sovereign finance crash affects us all], 240 pages with 21 charts, published by Verlag C.H. Beck, Munich 2010, EUR 19.95.

First and foremost, however, such a system is one of the central requirements for the credibility of the no-bailout clause, and thus also for the functionality of the European Stability and Growth Pact.

The May 2010 decisions opened up a window of opportunity for a fundamental reform of financial markets and the banking sector toward such a robust and resilient system. So far, European policy has not moved substantially in this direction, and the window for such a reform is closing quickly. ◀