Regulatory Gaps and Market Discipline: the Sovereign Crisis

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Presentation to a Conference organized in honor of

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At the University of Cyprus

September 13, 2011

The sovereign crisis is evolving rapidly and the multiple lessons from it will still be forthcoming. Yet, if we combine the insights from the financial crisis that erupted in 2007-8 and the current condition of markets around the world, we are able to draw a few conclusions and preliminary lessons. Some of these, especially regulatory gaps in sovereign markets, go relatively unrecognized even today. In this paper I plan to look at the lessons that the crisis of 2007-8 bequeaths to the sovereign crisis.

I. ***Market Failure and Policy Response: Basic Lessons from the Crisis of 2007-8***

To provide context for the discussion of the sovereign crisis, we need to recall the main policy responses to the financial crisis of 2007-8. The theory behind policy has as a starting point a broad recognition that financial markets were engulfed in failure of market discipline, and that a broad set of negative externalities were linked to this failure.

A long list of commentators in scholarly work and public debate have underscored that the crisis of 2007-8 originated in a 'shadow financial sector', an unregulated and unsupervised area of financial transactions. This was the subprime mortgage loans sector which inflamed a huge bubble in housing prices.

It was easily concluded that it is necessary for regulation to be comprehensive and not leave open unsupervised spaces that act as magnets of risky and potentially destabilizing undertakings. Another conclusion is that bubbles must be watched and forestalled; their burst will almost surely create negative externalities by stretching credit providers who lend against overpriced assets.

A parallel line of analysis has been based on the notion that moral hazards created by government guarantees came to roost. Essentially, the whole notion of moral hazard is of a mechanism that bypasses bona-fide market discipline and allows, for example, decision-makers to assume large risks beyond the point where self-interest is checked by self-preservation.

Up until the time of the Lehman default, the widely held assumption was that it, and similar firms, would be bailed out by the US government. The reversal of this conventional belief produced both a liquidity crunch and contagion. Market participants make and reproduce conventional assumptions which enable unsustainable market valuations.

The fact of the matter is that, in the end, the crisis of the sub-primes proved to be extraordinarily contagious. It produced a general financial crisis in many markets and countries. The underlying mechanism for the contagion has been the interdependence of the balance sheets and of the liquidity needs of financial and nonfinancial firms. The scarcity of liquidity and

the credit crunch that followed the Lehman failure was the mechanism that transformed the financial to a general economic crisis.

One simple lesson that we must not ignore is that contagion is par excellence the disease of financial globalization. Nevertheless, the policy conclusions from contagion have not been taken in the direction of restraining or regulating aspects of globalization but rather in making financial agents more resilient to crisis in a context of unfettered capital flows. Stronger capital and liquidity requirements for banks and insurance companies have represented central policy response in this respect, as they are now being embedded in the new regulatory regime for banks, Basel III.

The existence of financial cycles which had not figured in earlier policy analysis has now been explicitly recognized. Anti-cyclical provisions are being designed for capital adequacy regulation of banks in the context of Basel III. A welcome institutional response to the crisis has been the creation of systemic risk boards that will become a basic pillar for the exercise of 'macro-prudential supervision'. This is undoubtedly a positive step. Yet, I believe there are unresolved issues with regard to the scope and the toolkit of this regulatory innovation. How far will the mandate of these boards go as experience piles up and as a new financial cycle emerges? Will they actually undertake to suppress financial cycles or only to mitigate their consequences? And how closely will macro-prudential policy become entwined with monetary and fiscal actions vis-à-vis financial markets which become entrapped in self-feeding loops?

Fundamental policy towards financial cycles must be proactive. Given the destructiveness of the recent crisis, implementation of a proactive policy is fully legitimized. But there is a whole field of options and possibilities for policy. In any case, the true policy of systemic protection is the policy that will unfold not now, in the midst of crisis, but tomorrow when a new phase of euphoria renews the financial cycle. That will be the time at which systemic boards and anti-cyclical policies will be really put to the test. The present task is still one of preventing financial collapse.

Another clear policy response relates to over-the-counter derivatives markets. The basic issues here are twofold: on one hand there is need for comprehensive transparency so that inter-linkages can be observable at least by regulators. On the other hand, the risk of uncovered bilateral contracts must be mitigated by capital requirements on the issuers of options. To my thinking the needs here are basically simple: a restriction on tailor-made contracts, a regulatory policy on licensing contract origination, and a push for all options to be listed on organized exchanges with all the safeguards that these exchanges afford for safety of transactions, clearing and execution. Again in this area there are many debates and considerable ambivalence about the depth and breadth of reform.

Much of the ambivalence that characterizes the current discussion on the scope and the depth of proposed regulations in all the areas, relate to a basic counterargument: New constraints and regulatory intrusions may threaten the liquidity of markets; they may raise the cost of funding for financial institutions, at first pass, and for real investment, at second pass. Hence they may prove to be anti-growth and end up prolonging the crisis.

At a time of liquidity crunch this can indeed be a powerful platform. But it is a myopic one. Ample liquidity and low cost of capital cannot only be assessed in comparison to the conditions that prevailed at the height of the financial cycle that preceded the crisis. The real question is the impact of regulatory reform in the long run. The long run problem in turn is one which depends on whether regulatory reform will manage to compress financial cycles and to forestall runaway bubbles in asset prices.

In very simple terms then, it appears that whereas the contours of market failure are widely recognized, the parameters of regulatory response are unclear, ambivalent, and fragmented across the world with the possible exception of definitive rules on bank capital adequacy. Even in that arena however, implementation may be fragmented and uneven. In any case, a very basic lesson of the crisis is precisely the need for regulation to be global and comprehensive and to extend over the entire financial universe. Firmness in one area and ambivalence in others will drive changes in business models and may simply sow the seeds of future regulatory arbitrage. This can prove dangerous for the long run.

II. The Migration of Risk from Private to Public Finance: Striking Parallels

We should not allow technical complications to obfuscate basic facts. Much has been written on the crisis and the salvage operations undertaken by Treasuries and Central Banks in order to preserve the integrity of financial systems. The salvagers have taken on bad assets or expanded current spending by increasing their own liabilities. Money and public debt have been oversupplied. Hence a great migration has happened. Risks have travelled from private to public finance. Erstwhile riskless assets – securities issued by public sector entities – have now entered the calculus of risk and return. In a very real sense the government, whose actions had been conventionally thought of as exogenous to the financial market, has now become an endogenous entity. Not only is the government an issuer of risky securities, its default becomes a major component of 'systemic risk'.

I would like to briefly draw up the obvious parallel of the euro-zone crisis to the Lehman episode. Up until 2009 the conventional view that was widely held in global markets was that no euro-zone country would default as its partners would bail it out. This was a widely held convention despite the fact that it was not part of any treaty. It was 'priced into bond yields'.

The silent acceptance of this convention was not only a market misperception. It was also a political convenience for the European power structure. It enabled the maintenance of a strong euro and of easy finance for European economies. The discovery of a ballooning Greek deficit in November 2009 did not really unsettle the markets as much as the discovery two-three months later that the 'silent guarantee' did not exist and that the road to bailout was extremely tortuous politically.

Again, as in the case of Lehman, a widely held conventional assumption was overturned. This produced a contagious market crisis that now evolves in the financial spaces where sovereign debt is being transacted.

But the parallels do not stop there. The great financial euphoria of the years up to 2007 did not only subvert the conditions for market discipline in the financial sector. They also subverted the conditions for fiscal discipline in the public sector. Borrowing was extraordinarily cheap and gave an easy way out to political needs for expanding deficits; monetary policy was very lax without inflation; so lax that hardly anyone could imagine a liquidity crunch; within the euro-zone itself, deficit limits were violated by large countries – France and Germany – without giving any cause to negative risk assessments in financial markets. The message was not lost to other euro-zone governments however. Nor did it go unrecognized that the violations by the largest countries emasculated the status of the European Commission as guarantor and arbiter of fiscal rules.

Greece itself has been castigated repeatedly as a 'bête noire' for false accounting and misrepresentation of deficits. Yet, the same Greece had been under strict European monitoring in the period 2004-7, when, according to current narrative, its finances were already getting out of control. That says something about the quality, objectivity and depth of European monitoring. I am not defending Greek mismanagement, but I do think that proportionality requires us to recognize that fiscal indiscipline was not exclusively of Greek making. There was clealry a systemic aspect to it.

There is another parallel that seems to go unrecognized but is nevertheless striking. As I mentioned earlier, it is widely recognized that the crisis started in an unregulated subsector of the financial system (the origination and securitization of subprime loans). The securities created in that subsector were opaque and their presumed quality was exclusively dependent on credit ratings produced by the rating agencies. It is striking that if we look at the subsector of sovereign debt securities we realize awesome similarities. The primary and secondary markets for these securities are very large and virtually unregulated. The 'fundamentals' of the issuers are quite opaque at least in the sense that many of them have hidden or unmeasured liabilities. The assessment of the quality of the securities issued by sovereign entities is almost exclusively dependent on credit ratings issued by the very same rating agencies that were protagonists in

the subprime lending markets. Thus again, the renewal of the financial crisis that we are now witnessing is springing up from an unregulated and opaque market space.

The unregulated status of sovereign debt markets has been based for many years on a series of assumptions. The first is that sovereign debt securities are basically riskless and therefore need very little regulatory supervision. Underlying that assumption was a deeper one: while private issuers must be controlled lest they seek to defraud investors, public issuers are above suspicion, their honesty cannot be questioned. The second is that since the origination of public securities is based on wholesale arrangements it is not necessary to introduce regulations with the goal of investor protection. Wholesale buyers are large institutional entities that can presumable undertake due diligence and protect their interests. The third assumption is that in secondary markets of sovereign debt it is necessary to maximize the degrees of freedom and confidentiality of central bank action when conducting operations of monetary policy, without the interference and encumbrances of regulatory rules that exist in other markets. The fourth is that government issues should not be burdened with a host of requirements that accompany the issue of private securities lest this interferes with the liquidity needs of governments. In other words, governments as issuers of sovereign debt chose not to exercise their powers of regulation. Implicitly they accepted the argument made by private issuers that regulation increases costs without producing analogous benefit.

One result of these assumptions, and the unregulated status of government debt markets which they enabled, has been the opacity of the sovereign market. This in turn has maximized the role and the centrality of ratings and credit rating agencies. The less information is publicly available about the fundamentals of any issuer, the more concentrated is the power of and the dependence on ratings, exactly as was the case in the subprime market where the origination of securities was totally unregulated. {Ref. to V. Papaoikonomou}.

The ability of the raters to rate is itself subject to considerable question since there is no uniform standard of accounting for government entities. Government assets and liabilities are far less accurately measurable than the assets and liabilities of private firms which follow common accounting standards such as the IFRS. Thus, not only is investor due diligence more dependent on ratings, but the ratings themselves are far more subject to error, since the basis on which they are produced is itself opaque. Lastly, rating agencies have offered ample evidence of pro-cyclical behavior. Thus, the question of their methodology and their ability to form through-the-cycle forecasts is a matter of contention.

States are not firms, nor should they be. Their purpose is not profit but the welfare of their constituents, present and future. A democratic government is not responsible to shareholders but to voting citizens who have a variety of goals and needs. A state is a political entity whose survival may be predicated on economic integrity but whose progress is not simply measured

by economic surpluses. A state, unlike a firm, cannot be directly bought or sold, nor can it be simply liquidated. Finally, a state has explicit legal power over markets, the power of regulation.

All this however does not mean that the state is not subject to economic constraints and does not have to abide by rules of fiscal discipline. Quite the contrary is true. Fiscal indiscipline in the end undermines the welfare of citizens. Hence, the regulation of sovereign markets, while not necessarily duplicates of what holds for private issuers, must nevertheless be fashioned in ways that will introduce higher transparency in primary markets, strong prohibitions of market abuse in secondary markets, and significant regulatory restrictions of derivative markets.

A valid project for regulatory policy-makers in Europe, for example, would be to run through the entire toolkit of financial market regulations (e.g. prospectus, m.i.f.i.d, transparency, market abuse) and, instead of wholesale exclusions of sovereign markets, introduce a wide set of inclusions of these markets. All the qualities that differentiate states from firms imply that regulatory standards, including accounting and auditing standards, for states cannot simply be clones of private standards. But regulation there must be and feasible regulatory tools must and can be devised.

III. Private versus Public Moral Hazard: Reality and Rhetoric

Moral hazard is a very real problem in the operation of financial markets as the crisis has demonstrated. Salvage operations undertaken by governments and central banks after the crisis broke out are being criticized from the moral hazard perspective: present bailouts make future managers reckless and encourage further changes towards business models that favor extreme risk-taking. Indeed the scale of salvage operations imposed by this crisis is historically unprecedented and the arena for moral hazard will therefore be also much wider in scope than before. That is why many, including myself, have argued that post-crisis there is need for comprehensive regulation on an equally unprecedented scale, and that so far the scope of regulatory reform is limited in relation to the expansion of moral hazards. This is not what I want to dwell on here however.

The moral hazard argument has been extended to fiscal behavior in the Euro-zone. The argument, as articulated by several politicians and euro-intellectuals is that a bailout of an indebted state will encourage future fiscal recklessness by it and others. Hence, bailouts must be as limited as possible and regulation of post-bailout fiscal behavior must be tightened. In theory the argument seems sound. In practice it is not as applicable as it looks prima vista.

My main point here is that the ultimate stakeholders in states are not like the stockholders of corporations, since they do not enjoy limited liability. The constituents of the Greek or the

Spanish Republic do not have a floor on losses if their states fail. They can lose everything. Furthermore, the present crisis has already visited on countries with indebted states very real and substantial pain. But the essence of the moral hazard argument is of course that those who make reckless choices are absolved of the pain they cause. Hence the rhetoric of moral hazard is not applicable.

One may of course counter-argue that the managers of fiscal affairs, the political classes not the voters, are the real culprit of reckless behavior, and that the emergence of moral hazard is in fact mediated by an agency problem. This is indeed a valid argument, but its power is limited by the fact that in Greece, for example, the government is facing a huge political cost and the political class is feeling considerable pain: the pain of a generalized anger and of widespread mistrust. In this context the moral hazard argument as applied to sovereign entities becomes highly debatable.

IV. *Concluding Remarks: The Indebted State, Market Discipline and Growth*

Age-old wisdom and current scholarship agree on a simple dictum: an over-indebted state can grow out of debt or default, or, maybe, do a bit of both. The growth option has obvious welfare advantages, it can be cast as a Pareto optimal outcome: It can improve the position of creditors without worsening the burdens on taxpayers and without inducing tax revolts. The default option can be suboptimal in that it leaves everybody worse off, yet as an option it is operationally much simpler and less tortuous than the growth option.

Default means that you simply do not pay. Growth means, as we know, a complex set of initiatives that require money and organization. It is easy to 'default by default', by not doing much, or by being politically inept and/or irresponsible. It is impossible to 'grow by default' or by being politically inept and irresponsible.

The sovereign crisis means that indebted states are faced with very harsh conditions of market discipline. Market discipline in present day conditions of crisis and globalization is harsh because it is highly short-termist and because capital is very mobile. Market time and political time are very different. Markets require quick action but growth initiatives, including government and entrepreneurial decisions, require time, organization and patient finance. How will this quandary be resolved? Can a society going through adjustment – cum – recession find organizational resources for growth? And who has the ability to provide time and 'patient finance'?

In present day Europe this is only possible by a consolidation of fiscal power vis-à-vis markets. European initiatives for growth are the only way in which, ultimately, creditors' long-run

interests will be reassured and confidence will be gradually reestablished. It is from that realization that the attractiveness of proposals such as Eurobond issues arises. Whether this will happen or not is clearly a political challenge for the European power structure. And it has become even more of a challenge after the recent German judicial determination in that country's constitutional court!

The Euro-zone, as a sum of segmented actors, is weak and crisis prone. The Euro-zone as a unified entity can be a formidable fiscal actor. The rational choice is obvious, but it must overcome equally obvious political constraints of national politics and nationalist perspectives.

Many argue that Eurobonds be implemented rapidly as a method for the effective defense of the Euro-zone against the spreading financial crisis. The project, if it were to become politically feasible in Europe would still require the setting in place of regulatory structures that will convert the sovereign market to a properly regulated locus of primary issues, secondary transactions and tertiary derivative contracts, such as default insurance options.