THE SOVEREIGN CRISIS AND MARKET INTEGRITY

Stavros B. Thomadakis

University of Athens

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The ongoing crisis in the Euro-zone is so intense that most commentators rightly focus on its fiscal and macroeconomic aspects. However, this is a market crisis and the perspective of market quality must not be overlooked. On the contrary, it must be placed at center stage. The crisis brings forth a number of issues that are linked to market integrity. These will be the focus of my presentation today.

The Virulence of Financial Crisis

Let me start with two propositions. The first is that financial crises are particularly virulent and dangerous when they occur in unregulated and opaque markets. The subprime crisis is a powerful example of this danger. It acted as a source of risks that were spread very widely but went unrecognized for a long time and ended up destabilizing the world financial system when they finally broke to the surface.

The second is that an abrupt loss of confidence breaks out with great force when 'common assumptions' and 'conventions' that have underpinned market behavior for a long time are falsified and proven unfounded. The Lehman episode was a precise instance of this proposition. Many assumed that the Bank was soundly accounted and audited and that it probably was too big to be left without a government bailout. When both conventional assumptions proved wrong the markets froze.

Take these two propositions and observe the inescapable parallels to the crisis of sovereign debt, as it now centers on the Euro-zone, but also more generally.

The market for sovereign securities is largely unregulated, as I will elaborate in a moment. Both at the level of issuer transparency and at the level of secondary market transactions and valuation, it is an opaque market. The securities issued by sovereigns are spread very widely with heavy holdings by financial institutions. They have been considered riskless securities for a long time and now that risks have emerged they are destabilizing the world financial system.

As for common assumptions and conventions, we can also note a clear parallel to the Lehman case. This is the case of Greece. Up until 2009 the conventional view that was palpably held in global markets was that no euro-zone country would default as its partners or the ECB would somehow bail it out. This was a widely held convention despite the fact that <u>it was not part of any treaty</u>. 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 governments. <u>Indications of a growing Greek deficit were available already from 2008</u>. Even the public admission of a ballooning Greek deficit in October 2009 did not significantly unsettle the markets. What did finally jolt them was the realization, two-three months later, that the 'silent guarantee' did not exist and that the road to bailout was extremely tortuous politically. That is when yields on Greek bonds took off.

But the parallels do not stop there. If I may generalize, the great financial euphoria of the years up to 2007 did not only subvert the conditions for market discipline in the financial sector. It 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.

<u>The Opacity of Markets for Sovereign Securities</u>

Let me go back to two main points. As I stated, sovereign markets do not compare well to organized and regulated markets for private securities. Generally, the unregulated status of sovereign debt markets has been justified by four premises. The first premise has been that sovereign debt is riskless. This is a premise that is falsified by current circumstances, especially with regard to issuers – such as Euro-zone members - who do not wield the powers and the tools of monetary policy. So I do not have to say more about that.

The second premise is that sovereign issuers are bulk issuers and operate in wholesale markets. Wholesale purchasers of sovereign debt are presumably able to undertake due diligence and to monitor performance in defense of their self – interest much better than retail investors. In fact due diligence has been largely outsourced to rating agencies, admittedly with the blessings of the regulatory community over many years. This arrangement is now highly questioned and in need of serious reform.

The third premise is that governments are always upholding the broad public interest, whereas in fact political interests change and electoral cycles influence government behavior in democracies.

The final premise is that sovereign securities are used as policy tools – for example in monetary policy operations – and must not be subjected to the tinkering appetites of securities' regulators who may pose questions of transparency, market abuse, or even securities' fraud.

All these premises are by and large based on 'fair weather' propositions whose validity is pro-cyclical.: they work in good times but they break down in bad times. This is equivalent to saying that risk-premia are less than they ought to be at good times and more than they ought to be at the lower end of the cycle.

Many of these fair-weather premises relate to a very basic question: the question of 'issuer transparency'. The 'fundamentals' of sovereign issuers are more often than not quite obscure; many of them have hidden or unmeasured liabilities as well as assets. Accounting systems are not standardized and comparability of accounts is compromised. In this respect, IFAC's continued pressure for the adoption of International Public Sector Accounting Standards (IPSAS) is a valuable initiative.

Furthermore, public auditing is also highly variable across jurisdictions and compliance to basic audit principles is questionable. The assessment of the quality of the securities issued by sovereign entities is not obstructed only by these technical obstacles however. It is also complicated by the fact that - unlike the case of private issuers who are subject to the business cycle - it becomes enmeshed with the political cycle and democratic electoral processes. This implies that the credibility of a sovereign issuer is subject to periodic or sudden upheavals, predictions of political change and assessments of the impact of political change upon the value of securities.

This complex task of assessing imperfect information and political volatilities has been almost exclusively relegated to credit ratings issued by the very same rating agencies that were protagonists in the subprime lending markets. In fact, I would argue that it is precisely the lack of adequate information that 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 and obscured by securitization practices.

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 measured than the assets and liabilities of private firms which follow common accounting standards such as the IFRS, for example. 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 unstable. 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 examination and regulatory intervention.

The Secondary Market for Sovereign Securities

The very lack of issuer transparency in the case of sovereign securities implies very serious asymmetries of information in secondary markets for public debt. As soon as sovereign securities come down from the pedestal of 'riskless asset' they are potential targets of market abuse, as all risky securities are. Insider trading and market manipulation are not the exclusive privilege of markets for private securities. In fact, they become more likely in the case of sovereign securities because information quality is lower and asymmetry higher. The question of market integrity is as valid in sovereign markets as it is in other markets. This extends to derivative products which are almost exclusively over-the-counter instruments attaching to sovereign securities. The potential for cross-market manipulative practices is therefore also a prominent possibility. Transparency and regulation are therefore required.

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 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.

The sovereign crisis poses a dual challenge for policies. On one hand there is a need for policy that will enable an exit from the current condition. On the other hand a challenge for more permanent policies that will safeguard market integrity also arises: that will prevent both the extension and the reoccurrence of the present condition. <u>The latter must be a broad reform of the whole regulatory system that underpins the origination, the circulation, the valuation and even the premature death of sovereign securities</u>.