# Eurozone and Sovereign Bonds - Past, Present and Possible Futures

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# Slip slidin' away

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- **45 seconds and counting**

- Not 45 seconds to the next EU emergency summit or to the end of the world, but on average the time a speaker has to get and keep his listeners' attention. If you don't get it, then you're toast.

- A few messages from this presentation: sovereign debt crises are not new and worryingly we know little about fiscal sustainability; it will of course be the new hot topic of economic journals, euromoney conferences etc. Post Lehman, Europe missed the opportunity to minimise the chances of a debt crisis by failing to pursue a European wide banking policy. Complacent issuers and investors plus some of the infrastructure of modern finance have contributed handsomely to current difficulties.

- The capacity of financial markets to repeat errors seems unlimited. Is that because the cohorts of traders and the narratives (tulip bulbs, railways, electricity, internet, cash flow waterfalls, collateral harvesting, spread convergence) keeps changing but the incentives (and human nature) don't? A changing narrative fools people into believing the most toxic four words in markets: "*this time it's different*".

- "Bad events" are often aired and discussed by market participants but the illusion of continuous and deep market liquidity fools people into thinking they can exit before other market participants; how else can you explain how Italy can go from normality to near bankruptcy (slight exaggeration) in two days, a few weeks ago, without any apparent "new" news? (I'm sure that "multiple equilibrium theory" and "tipping point theory" explain everything, if only I understood them )

# Slip slidin' away

- ## 45 seconds and counting

- Post WW II the developed economies experienced a debt super-cycle. The financial system and structured finance have been a big factor in driving excess debt The private sector is now trying to de-leverage quickly; governments initially tried to offset this demand fall via fiscal policy. But then they quickly moved to repair the "damage" this had done to their own sovereign balance sheets. You can't look at current debt problems without appreciating how it (partly) arose.

- If current debt is too high there are only a limited number of options: reduce current debt servicing costs, term out debt maturities, default (explicit or implicit), "free money" or debt forgiveness.

- Governments could have adopted a "war" stance; setting a high debt/gdp ratio as a rationale policy response (to a large private sector demand shortfall) *and* putting policies in place to reduce this over, say, a 10 to 15 year horizon. It is extremely difficult, if not counterproductive, for all governments to adopt strongly deflationary policies *at the same time. ("paradox of thrift" at a country level.* A higher "acceptable" level of debt (and a slower pay down of this) could have been part of the policy response*.*

- It also requires the right kind of fiscal stimulus (automatic stabilisers and measures that are easily reversed such as temporary tax reductions are preferable) and the right kind of quantitative easing (designed to hold down interest rates at the long end of the curve, not to directly finance big expenditure programmes)*.*

- In Europe the focus has been on trying to fool investors into believing that there is a sovereign liquidity crisis rather than a debt issue which could be managed or (in some cases) a high debt problem which can't be managed without default or restructuring.

# We can build this dream together

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## Scientists and investment bankers

- They both share the view that if it can be done, then automatically it must be a good thing and should be done. And if we (the good guys or Bank A) don't do it then someone else (the bad guys or Bank B) will. A lot of financial instruments have been created, simply because they can; often they are of dubious inherent value but with the capacity for great harm.

- For example what government or regulator in its right mind would permit credit default swaps (CDS) on their own debt, without at least making sure that basic insurance principles were applied? A cash settled CDS is just the same as insuring your neighbours' house, burning it down and claiming the payout. The global derivatives' industry now quotes net CDS exposures (because it's righty afraid that the much larger gross figures will make it a target for regulation); It's gross exposures and its concentration that can cause the problems.

- A lot of the harm of modern financial instruments stems from two factors: a lot of instruments increase the leverage in the system and do so in a disguised or off-balance sheet manner. Secondly one side of the deal is usually concentrated (e.g. the sellers of over the counter derivatives); concentration increases the risk that one player will cause a negative domino effect. The "risk-sharing" or "risk-dispersion" benefits of a lot of modern finance's inventions has been laid bare for what it is (not) in the past 20 years.

- Technology has also played its part. In constructing "cash flow waterfalls" and "instant hedging" programs at the touch of a button, and in facilitating financial disintermediation, technology fosters an illusion of detachment (of the final instrument from the underlying exposure that was used to create it). It contributes to making the buyers more speculator than investor; not a good outcome for the "system" as a whole, even if it temporarily benefits some individuals/institutions.

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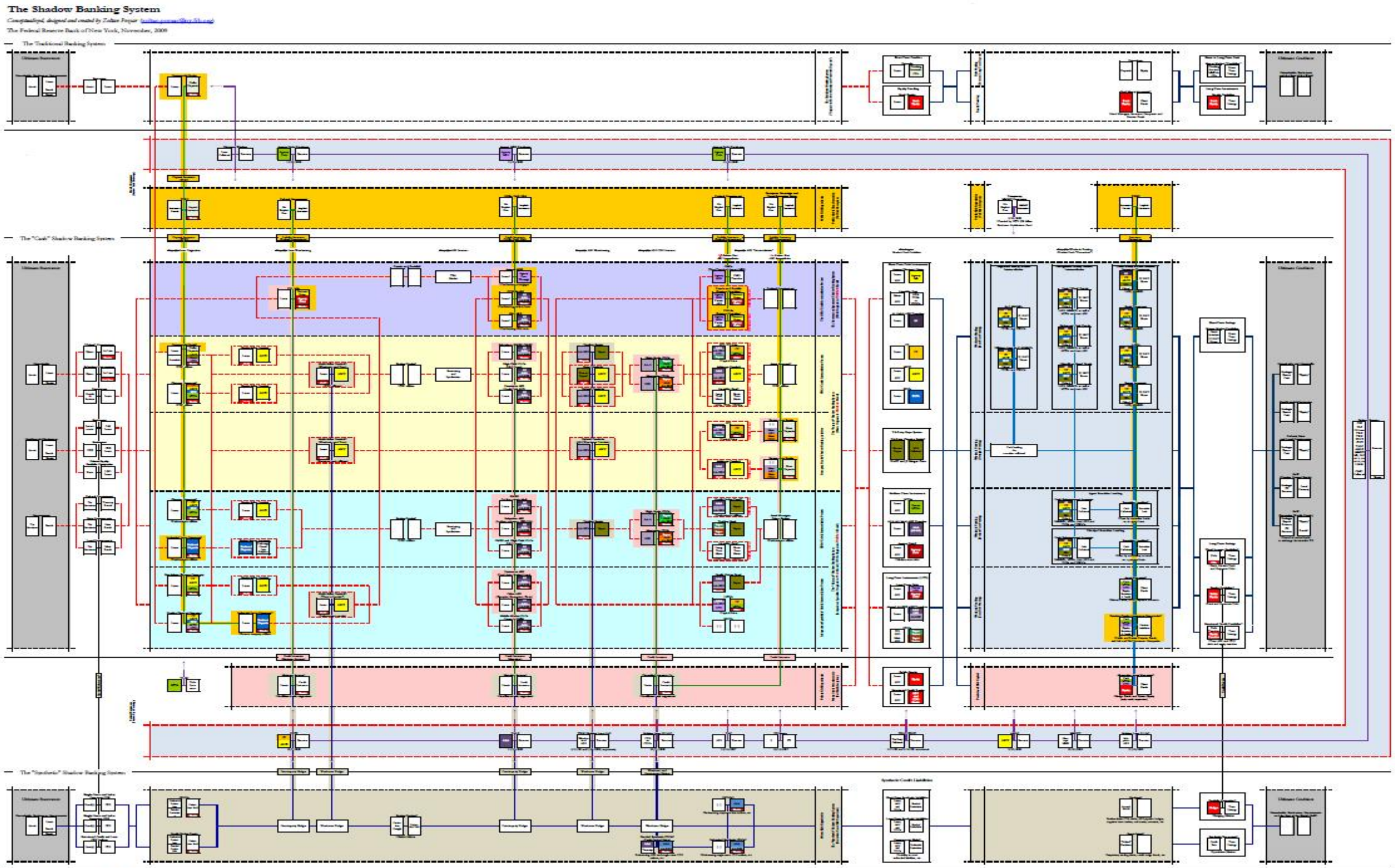
- **Scientists and investment bankers**

- Alan Greenspan embraced the whole edifice of technology-driven modern finance, underpinning a leveraged-fuelled bubble era, replete with moral hazard (Tequila crisis, LTCM, tech boom/bust). He seems surprised that his central credo (which he wrote about in 1960s) that banks and financial institutions would so value their reputation that they would not rationally put their own existence into doubt by undermining those reputations, was found wanting. His response is that we need better models. Maybe Alcoholics' Anonymous should advocate "just one more drink" for their recovering members?

- The next slide shows the traditional banking system and the "shadow" banking system of securitised assets etc. 80% of the slide is concerned with the shadow system. Can something this complex be monitored or controlled?

# Oh what a tangled web we weave: US shadow banking system: NY Fed staff paper #458, July 2010




Source: Shadow Banking (Pozsar, Adrian, Ashcraft, Boesky (2010))



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# This one is small, but that one is far away

- **Markets…Dougal or Ted?**

- Technology has arguably contributed to a loss of perspective in financial markets. You can "experience" anything via a Bloomberg graph or a colourful slide deck from your favourite sales' person. Just look at the education syllabus for market practitioners: very little financial market history let alone economic history is taught. This just increases the chances that past mistakes are repeated i.e. we don't see the changing narrative for what it really is, but rather what we want it to be.

- Perhaps it's just part of being an "advanced" society…we don't need to understand the past. And because we are so advanced we can control everything – financial markets and even whole economies – despite abundant current evidence to the contrary. And if everything can be controlled then nothing bad (governments defaulting, currencies falling asunder, markets collapsing) can happen or if it does it will be righted quickly.

- Oh and of course if a AAA- rated structured instrument yields 3 times as much as other AAA-rated assets then it must be true because some rating agency has constructed a model to show that it is. It couldn't be due to anyone leveraging an asset to produce the same effect and just calling it by another name. If you mentioned "leverage" to a CDO (collateralised debt obligation) salesperson they would recoil in horror.

# I'm a working man I am

## Benchmarks, career risk and unintended consequences

- Benchmarks such as the S&P500 equity index or eurozone bond indices are a key building block of modern portfolio investing. They contribute to the commoditisation of the investment universe i.e. making their individual components look the same or interchangeable. Their use as performance benchmarks drives many investors to replication strategies or strategies anchored in replication.

- In reducing the incentive (for investors) to significantly differentiate index components and treat each as distinct investments, it makes buyers more complacent than they should be. Sellers react to the same signals and thus can sell at a higher price than they otherwise would be able to. Thus once a country (let's say Greece) makes it into a certain benchmark then it opens up a whole new universe of potential buyers, who may not be (read *are not*) totally familiar with the merits of that country, other than the obvious i.e. it's part of what they are now being compared against.

- The sellers of the debt mistake this new-found interest in what they are flogging as a positive comment on its intrinsic worth or (much more probably) can't believe their luck and flog as much as possible while the going is good.

- An portfolio manager knows he won't be sacked for investing in Greece as long as it's within the performance benchmark (that a client or consultant has bestowed upon him) and he's not too far from the all of the others who are doing the same thing. In fact the incentives are likely skewed the other way entirely…he could be sacked for not investing in Greece because of the "performance shortfall risk" of having no exposure at all.

- The convergence in rates that these new cohorts of buyers helped to foster can produce a temporary virtuous circle for countries with underlying difficulties but the (excessive) access to debt while the merry-go-round is working merely postpones the inevitable.

- Note that the implications of your currency being a "reserve" currency e.g. the US and the US dollar, is akin to being part of a benchmark…you get investment flows for reasons other than the intrinsic merits of the country underlying the currency. It allows you to accumulate debts that you would not otherwise have been able to accumulate and/or at interest rates that you wouldn't otherwise access. But the real bonus is that you do so in the currency that you can print i.e. your own. The US doesn't have to worry about earning foreign currency in order to pay its overseas lenders. That considerably reduces the pressure that a creditor nation like China can apply to the US. (in extreme scenarios, It may even make it easier for the US to default selectively, to a foreign lender like China.)

# Hello… is it me you're looking for?

- ## The Kissinger Question and co-ordination failure

- The famous quote (probably apocryphal) is about "who do you call in Europe?" in a crisis …who runs the place?

- The only eurozone institution that can quickly make decisions is the ECB but monetary policy is only one aspect of the infrastructure of a currency. While the euro has been an incredibly successful administrative venture, that fact has blurred the reality that it is not (yet?) an optimal currency area. The reality is that there has never been a successful single currency without a central treasury and you're unlikely to have one of those without central taxation and you're unlikely to have that without a central government. Normally it's wars or conquests that forge countries (central governments), not voluntary unions.

- Co-ordination mechanisms, surveillance measures, stability pacts are no substitute for control. Markets sniff out this kind of weakness. Arguably in this, the first real crisis for the eurozone, the initial blood was scented post Lehman, with the response regarding the banking system; yes the ECB supplied system-wide liquidity but the solvency aspect of the banking system was dealt with at a country level, apparently at the insistence of one large country. There was no one institution whose function was to protect the banking system of the eurozone as a whole.

- This failure to tighten the architecture in Europe was a missed opportunity to deal with a fundamental flaw; it suggested that the desire for tighter union was not strong enough to satisfy investors. Investors have probed and probed the weakness in the system since that time. The poor reaction to successive emergency summits etc is proof of that.

# Mama I love you

- **Steamy windows and debt sustainability**

- What do we even mean by debt sustainability? Is it just the persistence of low'ish and stable long term interest rates? Or is it just a low'ish and stable debt/gdp ratio? Japan has had 10 yr interest rates below 2% for 13 years and yet its gross debt/gdp has risen continuously , to well over 220%.
- The point is that while we know the maths of debt/gdp ratios, (and those same maths were used to predict soaring Japanese bond yields, over many of the past 13 years) those maths don't help you very much. There are a multitude of factors that determine the supply and demand of government debt. Demographics and cultural factors for instance. We know that Italy is renowned for its "stay at home children" (single adults living with their parents, who have "dates" in parked cars) and also that its level of household debt is very low and the lowest in the eurozone. Those factors may contribute to higher savings that support direct and indirect purchases of Italian government bonds.
- If other assets are shunned (Japanese equities, in a deflationary environment) or if there are "forced" buyers (Asian "vendor finance" countries re-cycling their trade surpluses into US treasuries) then a particular level of bond yield can persist for far longer than might otherwise appear rational. Equally there can be apparent stability for years but then abrupt instability despite no proximate "new" news.

# How many roads must a man walk down?

- **“Cul-de-sac”-onomics?**
- The desire to “wish away” high debt levels is understandable if not flawed. Markets are not fooled by the complex smoke and mirrors’ operations that have been created in Europe in the past year and a half. The menu of options are limited in any debt situation: reduce current debt servicing costs, term out debt maturities, default, “free money” or debt forgiveness. A eurobond is akin to free money from the core to the periphery; the question is one of political will, so simple in theory, very difficult in practice. The practical problems will be solved once/if the principle is conceded.
- Policy reaction could have/can help to prevent a crisis spiralling out of control especially when the banking system is in the frontline of the problem e.g. a Europe-wide approach to the banking system would not have altered the fundamentals of Irish, Greek or Italian debt but could have limited the contagion effects
- Unanticipated inflation can help to “burn-off” debt relative to income (fixed numerator and rising denominator means that your debt/gdp ration can fall); it’s a way of pushing default onto savers (who lose unambiguously through this type of inflation). If it’s anticipated inflation then it’s harder to achieve what you want, because all prices will adjust, including the price of money (interest rates) so your debt burden relative to your income may not fall at all. Debt investors can shun government debt or seek debt with inflation proofing. “Burning” bond holders and savers via inflation is easier in a capital controlled world, which we don’t have currently, but which could yet return.