ISSN 1359-9151-240

Papers by Otmar Issing and Charles Goodhart on the occasion of a Conference in honour of Prof Ben Friedman, held in Frankfurt on June 24, 2015.

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SPECIAL PAPER 240

LSE FINANCIAL MARKETS GROUP PAPER SERIES

October 2015

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Some remarks on debt, default, and debt relief

Prof. Dr. Otmar Issing

Symposium to honour Benjamin Friedman

Frankfurt, 24 June 2015

The issue of debt, default and debt relief for long has caused problems in developing countries. The global financial crisis has brought industrialised countries into the centre of this debate. Most countries have accumulated much higher debt as a consequence of fiscal policies to stop the economic downturn. At the same time the piling up of tremendous amounts of household debt has directed attention to the dire consequences of such indebtedness for individuals. It is no surprise that debt, default and debt relief are at the centre of numerous studies, even going beyond economics into the fields of moral and ethics.

I will concentrate on sovereign debt, a foremost concern in Europe, or more precisely in the Eurozone.

One crucial aspect of having unprecedentedly high levels of government debt is very often neglected. This is that long-term interest rates are also at a uniquely low level. Governments worldwide enjoy a rapidly declining interest bill in relation to GDP. This situation is seen, by some economists, as an argument for taking on even higher debt. Demographics, however, in most countries would suggest a different message: reduce debt ratios and reorder priorities in the interest of the present young and future generations. Intergenerational equity has to be an important aspect of a moral approach to government debt.

Defaulting, by the way, could stop a country's access to financial markets, or would, at least, trigger a higher price needed to be paid to investors to hold debt of such a country.

Let me now turn to the Eurozone. As a monetary union of (in principle) sovereign countries, the no-bail-out clause is an indispensable element of such an arrangement. Eurobonds etc. would imply a transfer of taxpayer's money without democratic legitimisation.

The fundamental principles were established before the start of monetary union. In Germany people were anything but enthusiastic to give up the DM and were afraid that the euro might become a weak currency, and the euro area a zone of fiscal laxity. Against this background Chancellor Kohl, numerous other politicians and public servants amongst them leading central bankers, tried to convince the German people that their fear was unjustified. Their argument was based on the Treaty, the Stability and Growth Pact, and, last but not least, on the no-bail-out clause. Should they not feel morally committed to the implementation of these rules?

As we now know, all kinds of legal and solemn agreements were violated time and again – also by Germany herself. Even if one should tolerate single acts of these violations – and in the meantime the Eurozone as a whole plays to a very different tune than initially constructed and presented to the people – this has also led to a – mildly spoken – underperforming economic outcome.

So much for the economic side. But, what are the moral and ethical aspects? Part of the people – not only in Germany – feel betrayed, another part, i.e. mainly politicians and Eurocrats, wants European monetary union to go much further down the present route.

For me, the fundamental consequence is: Either EMU has to go back to its roots or we need a new Treaty on which the people must be allowed to express their preference.

The debate on the Greek debt and debt relief is just the tip of the iceberg of what I just have described. Benjamin Friedman has made a reference to debt relief for Germany 1953 (and before): "There is no economic ground for Germany to be the only European country in modern times to be granted official debt restructuring and debt relief on a massive scale, and certainly no moral ground either" (BIS Papers No.80).

I fully subscribe to this statement. But, I would add – the debt relief for Germany by itself is also neither an economic nor a moral ground for debt relief for Greece or any other country. Every case has to be judged on its own merits.

Greece's debt (before the crisis) was mainly the consequence of fiscal profligacy, especially due to the enormous increases of salaries in their bloated public sector. I am far from defending activities on the lending side – I had, and still have, not the slightest sympathy for bailing out French and German banks – but I think it means insulting the intellect of Greek borrowers to assume that they were unaware of what they were doing.

Finally, in 2012 private investors lost more than 50% of their investment – much more than 100 bn € – from Greek assets, the largest debt relief ever. And all kinds of debt relief via lower interest rates and longer maturities etc. by the ESM and ESFS, lead to a calculated net present value saving of more than 40% of Greece's present debt.

The question obviously is not whether Greece should be given debt relief – but if it should be given further round of such relief. What is the guarantee that, after such measures, the Greek government would start to fight corruption, tax evasion, etc. and not continue the bad policies of the past?

The moral hazard issue has to be taken seriously. When we talk about morality and ethics, one has also to look at the other side of debt. The Greek debt is now almost totally in the hand of public investors. It is taxpayers' money – also of countries poorer than Greece - which is at stake. Do they not deserve the same attention concerning the consequences of debt relief?

Finally, we have to turn to the situation in other countries. If debt relief becomes a feature of the Eurozone – what about Italy with a debt ratio of more than 130% - not so far away from that of Greece? What about Spain, Portugal?

Isn't the application of the moral argument in the end not arbitrary? Isn't it finally based on the presumption that the creditor is always in a morally inferior position? It is not surprising that a book like Graeber's "Debt. The first 5000 Years" ends with a plead for a general debt forgiveness, referring to the bible.

I leave it as an open question whether this would be the culmination of a moral society. It would certainly be the end of our welfare.

<u>The GFC was a Joint Crisis of Banking *and* Housing Finance</u>

The question to which I was asked to respond was whether the Great Financial Crisis was brought about by the fragility of the banking system. My brief answer is that this was one, but only one, of the causes of the GFC. In other words this accusation is true, but only partially so.

Although there is a well-known pedagogic model, the Diamond-Dybvig model, whereby bank runs are triggered by larger (than expected by banks) withdrawals by depositors who have become impatient, or spooked by a sunspot, I know of hardly any such cases. Instead, bank runs and bank failures are generally joint crises, when there is a sharp downturn in the valuations of an asset class which is held in significant amount in banks' asset portfolios. Concern about credit risk potentially impinging on bank solvency then leads to withdrawal of bank funding, usually starting with a run by uninsured, but informed, wholesale lenders to banks. Runs by retail depositors are rare, and usually occur late in the proceedings, when wholesale depositors are already long gone.

The asset class, whose cyclical, bubble and bust, phases, has most often interacted with a bank credit expansion cycle to cause really severe crises is property, both housing and commercial real estate; on this see the paper, 'Leveraged Bubbles' by Jorda, Schularick and Taylor, (Working Paper, 2015).

I have lived through three financial crises during my professional life. All these involved interaction between a property boom and a sharp expansion in bank credit. These occurred in 1974/5 (the Fringe Bank crisis), 1991/2 and 2008/9 (the Great Financial Crisis). You will note that all three were 17 years apart; using the most technically advanced econometric techniques, this enables me to predict that the next crisis will occur in 2025/26. Owing to the relatively few degrees of freedom, the Standard Error is so large that I cannot foretell with any confidence yet in which month it will occur!

To be somewhat more serious, deficiencies in the management of housing finance, in numerous countries, were as important a cause of the GFC as the problems with banking. Yet all the focus of reform has been on banking, with virtually no serious reforms applied to the structure of housing finance. This is a tragedy. Moreover, the concentration of such mortgage finance in the retail ringfenced banks in the UK, following on the Vickers Report, is likely to enhance the fragility of UK banking in future, rather than the reverse.

There are a lot of potential steps that could have been done to reform housing finance; the proposed Shared Responsibility Mortgage (SRM), suggested by Mian and Sufi, could have been one such approach; greater use of Danish-style covered bonds another; reform of the US GSEs yet another. The list of potential reforms is quite long, but the political will to revise the structure of housing finance is limited, in contrast to the eagerness to impose further constraints on the demonised and over-paid bankers.

Of course, much of the banking reform introduced in the six years, or so, since the start of the GFC was badly needed. In particular both the available loss-absorbing capital, and the proportion of liquid assets held on bank books, were far too low. Much of this has now been rectified, and rightly so.

Nevertheless, some of this reform has been misdirected, perhaps in particular the proposals for structural reform. These have focussed on, what has been described as, casino banking and the operations of the banks, particularly their investment banking wings, in derivatives. In practice, the derivative book of Lehman's was profitable, and, whereas some of the trading practices and proprietorial dealings of the banks were morally wrong, there is very little evidence, if any, that they played any role in setting off the GFC, unlike the excesses of housing finance which did. Thus a large part of the reform effort has been expended on structural reforms, some of which may be valid in themselves, but which had little relationship with the underlying causes of the GFC.

Moreover, whereas the need to increase the proportion of loss-absorbing capital to total liabilities on banking books was admirable, the way that this was done in Europe, in contrast to the procedures in the USA, was most unfortunate. Thus, required equity ratios have been sharply increased. Mark Carney used to say, until recently, that they had been increased by a factor of seven times. More recently he talks of an increase of ten times. But no constraint was placed on the way that bankers might achieve this much higher ratio. Given the focus of bank CEOs on trying to maintain a high value of their own Return on Equity (RoE), it was almost certain that banks would do so, given their freedom to choose, by deleveraging, rather than by raising new equity, except in extremis. Meanwhile, each national government was pressurising its own headquartered banks to maintain, or to expand, lending to SMEs and persons within their own country. The inevitable consequence was a massive fall in cross-border lending, and the fragmentation (Balkanisation) of the European banking system. In contrast, in the USA, following the 2009 stress test, the banks there were required to reach a particular amount of equity capital, and where they could not raise that directly themselves, it was in practice forced upon them by the use of TARP (Troubled Asset Recovery Program) money, on terms which were beneficial to the investors, i.e. the government and the taxpayers behind it. Far from being a burden on the taxpayer, in the US they actually obtained a net benefit through this mechanism.

The same should have been done in Europe, but was not, partly no doubt for political reasons. This has been one of the reasons for the much slower recovery, both of banks and of the economies in the EU. What a pity!