The Paradox of Confidence

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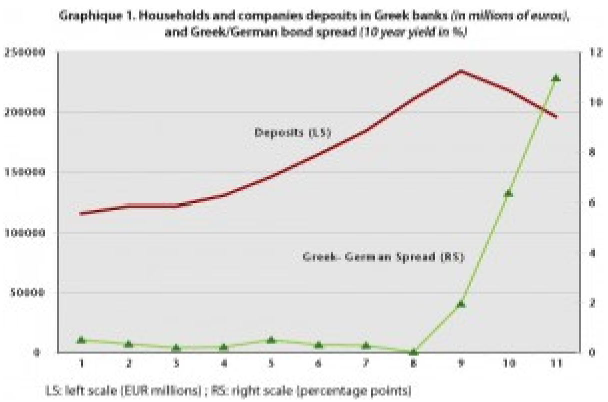
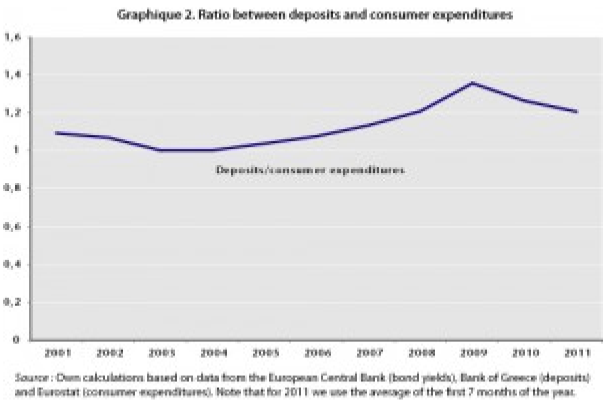
An interesting question raised in many forums is why Greek depositors continue to have confidence in their government while Greek bonds holders do not.

The Hellenic Deposit and Investment Guarantee Fund's (HDIFGF) derives resources from initial membership as well as from annual contributions paid by credit institutions. If these resources are not sufficient to compensate depositors in case of failures, supplementary resources are provided by the Central Bank (Law 3746/2009).

But in the case of a bank run, would the Greek government be able to pay those depositors without the help of the European Central Bank? The Greek debt is now 153% of the GDP, up from 106% in 2007. Is it reasonable to believe that the government can raise extra funds in case of a bank run without the need to print money and with no explicit guarantee? (In practice, the European Central Bank is not obliged to bailout Greek banks or to insure Greek depositors).

In the aftermath of Irish increase of the deposit guarantee in 2008, many countries followed suit in order to prevent depositors from looking for safer accounts in other European countries. Greece was one of them. It increased the insurance to cover deposits up to 100,000€. That might be one of the reasons why Greek bank deposits increased considerably during 2008 and 2009 (14.4 and 11% respectively). Although it seems to be that depositors are turning their back to the banks (deposits have been falling since then, -6.7% in 2010 and -10.14% during the first 7 months of 2011), once considering the effect of the fall of income, the deposit/consumption ratio is still over the average for the decade (the ratio between deposits and consumer expenditures is decreasing but it is still higher than what it was during the period 2001-2008, figure 2). Surprisingly, depositors' behaviour has not been really affected by the country risk (see figure 1, the spread of Greek bonds over the German ones is a measure of government risk and it has risen).





What makes Greek depositors apparently so confident in their banks? It must be recalled that beyond deposit insurance, it might take time if depositors were to get their money back in case of failures, (up to 6 months according to the HDIFGF – ask Northern Rock depositors for more information about the subject!). What would happen if eventually Greece decided to abandon the Euro? In which currency would depositors expect to be paid? In this case better ask the question to Argentinean depositors!

I do not want to spread fear among Greek depositors but to debate the implications of greater financial integration without an explicit European safety net. For example, should deposit insurance be a national matter or a European one? What about supervision? Today the centre of the hurricane is in Greece, but the risk of contagion to other countries is high.

Why the developed countries should renounce their AAA rating

By Catherine Mathieu and Henri Sterdyniak

By their very nature, states with monetary sovereignty should renounce their AAA rating: indeed, what is the logic behind having the rating agencies rate a state whose default is rendered impossible by its ability to create its own money? To avoid dependence on the rating agencies and put an end to the crisis in Europe, the Member States of the euro zone must recover their monetary sovereignty through the joint, virtually complete guarantee of their public debts.

Since 1945, no developed country has defaulted on its debt. There was no risk on the debt, since the states borrowed in their own currency and could always obtain financing from their central bank. The developed countries enjoyed "monetary sovereignty". This is still the case today for Japan (which enjoys 10-year loans at 1% despite a debt of 210% of GDP), the United States (which borrows at 2% with a debt of 98% of GDP), and the United Kingdom (which borrows at 2.5% with a debt of 86% of GDP).

Banks and insurance companies cannot function if they do not have risk-free assets and if they have to guard against the failure of their own state, which is of course impossible: the amounts involved are enormous, and government securities serve to guarantee banking and insurance activities. The banks and insurance companies could not accumulate enough capital to withstand the bankruptcy of their own country or multiple euro zone countries. As we can see today with the sovereign debt crisis in the euro zone, such a requirement would lead to the general paralysis of the banking system.

It is fundamentally absurd that the rating agencies rate a state with monetary sovereignty, as if its default were an option worth considering. States with monetary sovereignty should renounce their AAA rating: by their nature, their debt is risk-free because it is guaranteed by the central bank's power to create money.

The euro zone countries have lost their "monetary sovereignty": under the Treaty of the European Union, the European Central Bank has no right to finance Member States, and the States are not bound by joint liability. The financial markets noticed this in mid-2009, and suddenly uncontrollable speculation erupted, targeting the most fragile countries in the zone: first Greece, Portugal, and Ireland, which had the fastest growth before the crisis, but will have to change their growth pattern, and then, like dominos, Italy, Spain, and even Belgium. Today, Belgium has to pay an interest rate of 3.8%, Spain 5.2% and Italy 5.6%, compared with 2.6% in France and just 1.8 % for Germany. Greece, Ireland, and Portugal are now in the situation that the developing countries faced yesteryear: their debts have become risky assets subject to high risk premiums, and they are being brought under the yoke of the IMF.

The workings of the financial markets could completely paralyze fiscal policy. When a country enjoys monetary sovereignty, then in a recession the central bank can lower its maximum interest rate and if necessary commit to keeping it low in the long term; the state increases its deficit, but the low interest rates prevent the debt from snowballing; and it pushes exchange rates lower, which boosts activity. Since the debt is guaranteed by the creation of money, there is no risk of bankruptcy, and thus no reason to have to constantly *reassure* the markets. The central bank, by maintaining long-term rates at low levels in a recession, ensures that fiscal policy is effective. Fiscal policy does not need to worry about the markets. This is still the strategy of the United States today.

In the euro zone, the risk is that in the future a country could no longer increase its deficit for fear that the agencies might downgrade its rating and interest rates would then soar. The countries are therefore condemned to prove their virtue so as to appear as wise as Germany in the eyes of the markets. This renders their fiscal policy impotent, and their economic situation spins out of control (see, for example, *The impossible programme of the candidates for the presidential election*). The public debt becomes a permanent risk factor, since the states are at the mercy of the markets' insatiable appetite. Any economic policy should of course be assessed while taking into account the views of the markets. Yet the markets have no special competence in macroeconomics. They impose austerity policies during a recession and then turn around and complain about the lack of growth – which is exactly what they are doing today with respect to the euro zone in general, and Italy and Greece in particular. They are promoting free market reforms such as cutting social welfare programs or the number of teachers. For countries to retain the ability to regulate their economic activity, the risk of default needs to be zero.

The euro zone must thus choose between dissolution and a reform that would guarantee the public debt of the Member States, which would re-gain their "monetary sovereignty". European public debts should become risk-free assets, compensated at low rates but guaranteed in full (by European solidarity and fundamentally by the ECB). This is the only way to maintain the independence of fiscal policy, which is essential given the disparities in Europe and the loss by each country of its monetary and exchange rate instruments.

The functioning of the euro zone was not thought through at the time of its creation, particularly with respect to the trade-off between “autonomy of fiscal policy / single currency / monetary sovereignty”. Joint liability creates a moral hazard problem, as each country can increase its debt without limit, but a lack of a guarantee leaves the field open to the play of the financial markets, which are constantly on the lookout. The guarantee cannot be limited to countries that meet the automatic rules, which is unwarranted economically and fails to comply with the Stability Pact. It should be automatic and total. To avoid moral hazard, the European Treaty should include a provision for the extreme situation where a country carries out an unsustainable fiscal policy, in which case the new debt of the country would no longer be guaranteed – but this should never come to pass.

Freed of the need to reassure the markets, the euro zone countries could engage in differentiated but coordinated fiscal policies, with their main objective being to ensure a return to a satisfactory level of employment consistent with low inflation.