Time to expose the reality of ‘debt market discipline’

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Adam Tooze, *Social Europe*, May 25, 2020

As another sovereign-debt crisis looms, Adam Tooze warns against repeating the mistake of delegating to anonymised ‘markets’ accountable political choices.

Adam Tooze

We are headed into a high-debt future. The recent Franco-German proposal for a European Recovery Fund shifts the burden somewhat off national balance sheets. If it comes to pass, €500 billion for a common fund will be significant. But by 2021 Italy’s debt will likely end up above 150 per cent of gross domestic product. France will find itself with debts running to over 120 per cent of GDP.

Will this turn out to be a source of instability and danger? The toxic legacy of the eurozone crisis might suggest so. Between 2010 and 2015, the normal operation of European politics was repeatedly disrupted and the economy of much of Europe plunged into prolonged recession, in a desperate struggle to stave off a sovereign-debt crisis.

One conclusion one might draw from that traumatic experience is that debt is best avoided. If this is coupled with a call to raise income tax progressively, tax wealth more and crack down on tax evasion, there is something to be said for the position. But it is not just unrealistic—it is disabling. Properly managed, sovereign debt has been an indispensable tool of modern government. Rather than avoiding them, Europe should face its debt demons.

Not preordained

The eurozone bond crisis was not preordained by tensions between democracy and capitalism, citizens and markets, national taxpayers and footloose financial cosmopolitans. The euro area made its own, very peculiar, sovereign-debt crisis. It now has the power not only to unmake the conditions of that earlier crisis but to found a new financial and monetary order—not just with regard to fiscal policy and the constitution of the European Central Bank but the structure of the bond market itself.

In general, since 2008 global bond markets have been tame beasts. Since the subprime-mortgage crisis, shell-shocked investors have been only too happy to lend to relatively safe sovereigns. Even the United Kingdom, embroiled in its shambolic ‘Brexit’, has been able to borrow on favourable terms. Preferred borrowers in the eurozone, such as

Germany, have seen their interest rates slide into negative territory. In the face of the Covid-19 shock, the trend has continued: as debts rise, interest rates fall. Creditors appear to have virtually no leverage.

That bond markets were so dominant with regard to weaker members of the eurozone at the height of the crisis in 2010-12 was anomalous. No doubt the financial situation of Greece was hopeless and that of Spain, Ireland and Italy difficult. But the pressure was massively amplified by self-imposed institutional constraints, strategic inaction by key European states, notably Germany, and a dangerous cat-and-mouse game played by the conservative leadership of the ECB under Jean-Claude Trichet.

The bond markets did, indeed, act as enforcers, but in doing so they performed the role less of freebooting market vigilantes than of paramilitary hit-squads operating with the connivance of the authorities. The weak structure of collective fiscal discipline was supplement by the threat of bond-market terror.

Perverse results

Whose interest did this peculiarly dysfunctional European management of the sovereign-debt problem serve? At the moment of speculative attack, buying and selling is driven by profit-seeking and a flight to safety. It is tempting to conclude that investors and financial markets rule the roost. But it is anything but obvious that the shambles of the eurozone crisis was in the interests of financial capital in general. The results were often perverse. If you look at the miserable fortunes of Europe's banks since 2008 it would be hard to conclude the crisis was managed for their benefit.

The dysfunction resulted from political failure and, specifically, the tendency to substitute 'market discipline' for politics in Europe's incomplete monetary union. Relying on markets was a way to avoid hammering out and enforcing collective decisions. Among the many efforts to disencumber politics pursued under the sign of 'neoliberalism', this was among the more dangerous: in a crisis, what markets inflict is not so much rational and sustained discipline, but panic. Far from depoliticising fiscal and monetary policy, the result was to stoke resentment on all sides.

The veiling and unveiling of the 'invisible hand'—the sense that hidden forces are at work—encourages animosity and rumour. In 2010 French and German bankers accused each other of having violated the standstill agreement with regard to Greece. In 2011 those around the Italian prime minister, Silvio Berlusconi, were convinced Deutsche Bank was selling Italian debt on the prompting of the German finance ministry.

Meanwhile, the economist Hans-Werner Sinn has made a career out of scaring the German public about TARGET2 balances. Italians see the same numbers as a record of capital flight and Germany's exorbitant privilege. Almost a decade later, the eurozone's bailout fund, the European Stability Mechanism, is still too toxic to touch.

The ironic outcome of this failed strategy of depoliticisation was that, at the height of the crisis, investors themselves were calling for more politics, not less. What they wanted was a sovereign commitment to back the euro and that is what the ‘whatever it takes’ affirmation by the then ECB president, Mario Draghi, delivered. It was from that moment in 2012 that the bank derived its expanded mandate to intervene, on which we are still relying in facing the Covid-19 crisis. But this being the European Union, the logic of ‘whatever it takes’ has to be reconciled with the restricted mandate of the ECB. This requires some nimble economic and legal argument.

Exemplary clarity

The economic argument is laid out with exemplary clarity in the commentary on the ECB’s Pandemic Emergency Purchasing Programme of 2020 by Olivier Blanchard and Jean Pisani-Ferry. The basic justification for ECB intervention, they argue, is that markets are not always functional: ‘Markets everywhere can become dysfunctional. Some investors have to sell to get liquidity. Others may not have the liquidity to take the other side.’

Furthermore, the market equilibrium is not determinate and cannot be assumed to be optimal. Markets have multiple equilibria. Some are good equilibria, in which investor confidence supports low interests and the eurozone’s debts are supportable. But there also bad equilibria, ‘in which investors get worried, ask for a higher premium, increase debt service, and in so doing make their worries self-fulfilling and make debt unsustainable … Multiple equilibria can emerge nearly at any time, but they are more likely in the current circumstances when investors are edgy.’ If investors are effectively pricing in the end of the world, then the ECB has a mandate to protect the euro.

The argument offered by Blanchard and Pissani-Ferry is designed to navigate two reefs: the conventions of mainstream economics on the one hand, the mandate of the ECB on the other. They define the precise circumstances which justify intervention, not so much as the right and proper thing for a central bank to do but as an exceptional intervention with regard to anomalous market conditions.

But as Blanchard and Pisani-ferry admit, what they are doing is perpetuating a makeshift solution. They do not lay out a future path. Indeed, as they remark, given the nervousness of markets about the huge scale of eurozone sovereign debts and the possibility of inflation or debt restructuring, ‘remaining silent about what will be done in the future may indeed be the best policy [for the ECB to pursue] today’. This is realistic but also a deeply disillusioned conclusion: Europe will continue in a balance precariously maintained by more or less contorted makeshifts.

This leaves it vulnerable to unanticipated shocks and dependent on *ad hoc* judgements. As Blanchard and Pisani-Ferry themselves note, relying on the ECB to manage the market continually is not a strategy without risks: ‘Distinguishing between the emergence of a bad equilibrium, and a justified increase in the rate in the good equilibrium is not easy, and the central bank may find itself taking credit risk.’ Were the ECB to suffer major losses on its asset purchases, political and legal fallout would no doubt follow.

This is cogent. But it should not be mistaken for a continuation of Draghi's logic. Draghi's 'whatever it takes' was not framed by a refusal to talk about the future. His move was justified by the expectation that Europe would move towards ever greater coherence of fiscal and monetary policy—precisely the issues Blanchard and Pisani-Ferry hold in abeyance.

Three pillars

Conditions today are not those of 2012. The coronavirus crisis and its aftermath, the green energy transition and the ageing of Europe's population pose radical challenges. Europe may be able to meet those challenges with improvisation. In the best case we dare to imagine that Europe undergoes a Hamiltonian moment and evolves towards something more like a coherent 'united states'. But what if we were just a bit bolder and envisioned, even if only as a thought experiment, a more radical reconstruction of its fiscal, financial and monetary constitution—a reconstruction that disentangled the haphazard mixture of political and financial disciplines which have marred its development to date?

Clearly, this would start with building a real fiscal pillar, in which common borrowing is linked to robust and uniform revenue-raising. This is where the Franco-German proposal, if it wins the support of the rest of the EU, might lead us.

The second plank should be a modified mandate for the ECB, which widens it to cover adequately the central bank's actual responsibilities. The German constitutional court itself has insisted that price stability is no longer enough—it must be balanced with other economic and social interests. Rather than the savers at the top of the judges' minds, however, the mandate should include a commitment to maximum employment and environmental sustainability, with priority given to the goal of decarbonisation by 2050.

Unlike the Hamiltonian progression in fiscal policy, this redefinition of the central bank's role would be a break not just with Europe's history but with the conventions of economic policy worldwide since the 1980s. Dropping the monolithic focus on inflation might spook the bond markets. They might conclude that an ECB required to consider the employment opportunities of Europe's young people needed to be disciplined by higher rates. Given the debt levels we are heading towards, such bond-market blackmail would be ruinous. Which is why a radical vision of a new financial constitution for Europe should involve a third leg—a reconstitution of the sovereign-debt market.

Strikingly vague

In conventional debates about sovereign debt strikingly vague terms are used. Blanchard and Pisani-Ferry speak of 'markets' and 'investors' being 'worried' and 'edgy'. But these markets are actually made up of a discrete group of more or less important actors, linked through particular networks of information and exchange.

Insiders know how to navigate the actually-existing sovereign-debt market. But they don't talk to outsiders or habitually lay out in intelligible terms what they do. Teams of expert investigators have embarked on major research projects to map the basic structure of these markets. Since 2014 the ECB has been collecting immensely detailed Securities Holding Statistics. But these are made available only in aggregated and anonymised form. Information on the ultimate recipients of bond coupon payments is held by private firms such as Clearstream, not public debt-management agencies.

We talk *ad nauseam* about debt-to-GDP ratios and make complicated calculations of sustainability. But we know shockingly little about to whom we are indebted and where our interest payments actually go.

As Tobias Arbogast has demonstrated in a recent working paper, an outline can however be sketched. He has traced out the tangled skeins not just of primary ownership but also the ultimate beneficiaries of the funds that manage Italian public debt. There is no single unified bond-owning class of *rentiers* living off Italian bonds, but an entire network of domestic and foreign banks, insurance funds and global investors. And still there are gaps, including a large category of extra-European investors, not banks, which seem to hold over €230 billion of Italy's public debt.

When we talk about anxieties destabilising the 'markets', whose confidence are we in fact talking about? We gesture towards broader categories: 'investors', 'fund-managers'. But who are they and what are their motivations? What specific pressures are they acting under? The ECB and market regulators no doubt have ways of answering these questions.

Following the alarming bond market instability in March 2020, economists at the Bank of International Settlements were, within days, able to identify the impact of certain hedge-fund strategies. But it was not their job to name names. The analysis of the BIS is just that—analysis. Not political; nor, at least in the first instance, regulatory.

'National team'

Characteristically, China has a more direct approach to such questions. When the market becomes unsettled and there is a whiff of panic in Shanghai, the authorities call on the 'national team'. This group of policy banks and investment funds is charged, on behalf of the People's Bank of China, with intervening, making loans and engaging in strategic buying of assets to sustain market confidence. They are not so much bond vigilantes as cheerleaders. It doesn't always work but it indicates a concerted tactical approach.

Once upon a time, Europe had national teams. The relationship between the French Treasury and Paribas is the stuff of legend. Indeed, a useful way of describing the unresolved constitution of the eurozone is that we are caught in an uncomfortable historical transition, between a fiscal and financial regime based on national teams of banks, central banks and treasuries and a new, more open, regime of sovereign-debt markets which lacks a definite shape in economic and political terms.

Tight entanglements remain, notably between Italian banks and their national treasury. But large quantities of eurozone sovereign debt are now held across borders. And, as Arbogast's data show, a substantial amount is held by international private investors, not sovereign-wealth funds as in the US. It was not by accident that Draghi delivered his 'whatever it takes' speech in London in to a gathering of sceptical global hedge-fund managers. He was daring them to do their worst while warning them against doing so.

Who owns what

One constructive proposal touted last year by the German finance ministry was to tweak regulations so that all European banks would hold similarly balanced portfolios of national sovereign debts. Rather than Italian banks holding Italian debt, everyone would be induced to hold a balanced portfolio of all the sovereign debt of the eurozone. This would in effect create a 'European team', binding European banks collectively to the eurozone's sovereign debtors as a group.

This points a way forward because it speaks to the actual undergirding of the sovereign debt market. It addresses the question of who owns what debt. Posed in this form, the question of eurozone banking regulation becomes a matter of the fiscal and financial constitution.

Whichever direction we move in, we should demand transparency. Who holds what? Who is buying sovereign debt? Who is selling? Which firms? Names and addresses please. And we need to know who exercises control and who are the real beneficiaries. It is the balance between the interest payments to the ultimate beneficiaries and the revenue flows to the tax system that decides in which direction debt finance redistributes income.

We need a comprehensive map of the hybrid network of public-private power which defines the circulation and ownership of sovereign debt. This network involves complicated legal and technical arrangements. It involves computer systems and financial engineering. But it also involves people.

Who are the men and women engaged in this buying and selling? We know there is a revolving door between public and private finance. How does it operate? If someone moves from a national treasury or a central bank to a lucrative position in the private sector, or the other way around, we as taxpayers ought to be entitled to know.

Furthermore, we need to know the wider field: the strategists, the 'quants', the bond-market intellectuals, the ratings agencies and their lawyers. The ECB has made its purchases of bonds conditional on decisions by the agencies. They, therefore, fall squarely within this new politics of transparency. And the lawyers are crucial. Debts are legally coded; they can be uncoded and recoded. Who has the expertise and how, if necessary, does one mobilise counter-expertise?

If you deal in sovereign debt you are not trading in any old IOUs: you are dealing in the 'IOUs' of sovereign states. The fact that we must pay our taxes makes the interest payments on those debts particularly safe. If we have enshrined price stability as one of the objectives of the central bank we have made a further concession to bondholders. In return, the least we can ask is to know precisely to whom we owe what obligations and how the terms of the debt are shaped, down to the nitty-gritty.

Redefining the boundary

Clearly, this call for radical transparency would imply a redefinition of the boundary between public and private, between financial markets, politics and state. Might it deter investors? Would it subject them to unacceptable scrutiny? Well, it would involve a power shift. The aim of the game is to prevent the reverse—the humiliating subjection of politics and the state to private financial power.

But in so doing the point is not to demonise bondholders and fund managers. The aim is to clarify the politics of public debt, to replace fearmongering and bullying with information and serious scrutiny. Given the high-debt world we are heading into, we are going to need to overcome the muddle in which we find ourselves.

And if naming and shaming is involved, it is not just investors who should feel uncomfortable. After all, the fund managers and ratings analysts are simply doing their job. The true embarrassment lies elsewhere—in Europe's collective willingness to rely on 'market discipline' as a substitute for political and constitutional agreement. It is the abdication of politics that has made eurozone sovereign debt unsafe.

In 2010-12 that abdication did disastrous damage. Faced with the financial legacy of the Covid-19 crisis, we cannot afford a repeat performance. The purpose of a radical new transparency with regard to sovereign debt should be to block any further evasion: by exposing the actual workings of what we call the market, to summon politics to its responsibilities.

This article is a joint publication by Social Europe *and* IPS-Journal