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Sovereign debt crises and financial bailouts: the anatomy and components of an everlasting relationship (I)

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ABSTRACT

This paper highlights why financial bailouts are an inevitable and necessary element in global efforts aimed at ensuring that financial stability is sustained. How could such bailouts be conducted in such a way that moral hazard does not become a too frequent, ever recurring issue?

Systemic risks constitute a crucial reason for the need to avoid global instability. Adequately and promptly responding to “too big to fail” institutions and nations also constitutes a crucial component of the need to avoid and contain the spread of systemic risks.

Key Words: systemic risks, financial regulation, sovereign debts, bailouts, moral hazard, supervision, monetary, fiscal policies, IMF, monetary unions, regional unions

Sovereign Debt Crises and Financial Bailouts: The Anatomy and Components of an Everlasting Relationship (I)

*Marianne Ojo*¹

A. Introduction

Whilst mutual respect is certainly a pre requisite and necessary foundation for a successful and lasting relationship, an even more vital bedrock can be evidenced and illustrated through mutual dependency and respect. In further illustrating such a point, the reasons behind the European Central Bank (ECB)'s willingness and efforts in providing Longer Term Refinancing Operations, as well as facilitating bailouts, could be justified as well as questioned. Furthermore, its patience in the provision of such facilities, in the earnest expectation that those countries most affected by the Euro sovereign debt crisis, would optimise the opportunity and time provided by the supply of liquidity support, is not only indicative of some element of trust and confidence reposed in such countries, but is also considered to be a way of encouraging countries who are most severely affected by the sovereign debt crisis to increase their maximisation potential in respect of the level of returns to be expected from reposing trust and funding in these countries.

Why Should (and why does) the ECB Count On Countries Worst Hit By the Sovereign Debt Crisis?

The reason why the ECB should expect and hope for positive results in return for its efforts in purchasing bonds and providing liquidity assistance to countries such as Greece, Spain, Portugal and Ireland, can be linked to the importance of such countries in its policy and decision making processes.

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“The ECB has purchased bonds issued by euro zone governments in recent years, to try to support demand for the debt, as well as drive down yields, which move in the opposite direction to bond prices. Even though the effectiveness of such bond buying, known as the ECB’s Securities Market Programme has been criticised by many policy makers who regard it as parallel to central bank financing for governments – an activity which the ECB is prohibited from providing, it is also highlighted that there is expectation from the markets that the government should use the time bought by the liquidity to deliver.”²

The dependency of the ECB on countries such as Greece, Spain, Portugal and Ireland can be considered to be greater than that of the International Monetary Fund (and also in respect of those other countries whose purposes it serves), from the viewpoint of regional association. Irrespective of their Euro currency links, the state of the economies of these countries (Greece, Portugal, Spain and Ireland) affects that of their neighbouring counterparts, as well as the ECB’s policies and decision making processes on financial stability measures and systemic risks to a larger extent. This leads to the first of the essential components of “the everlasting relationship” of the continual supply of liquidity funding and the need for such supply. It will also be highlighted later on in the paper that numerous measures aimed at supporting demand only serve as temporary measures and that over reliance on such, may eventually result in other crises of their own.

B. Anatomy and Components of an Everlasting Relationship

i) Diversity in a “Not So” Diverse World

Tourism: The local flavour, cuisine, weather conditions and other “exotic” and unique elements of certain countries constitute among several reasons why countries such as

2 J Wilson, “Official at ECB Hints at Fresh Bond Move” 2012 <www.businessdayonline.com>

Greece, Spain, Portugal and Ireland, top the list as favourites for European holiday destinations (excluding other countries such as Egypt, Cost Rica, Kenya, the Bahamas, Barbados etc). With particular respect to Spain and Greece, this is a tradition that dates back to as far as the origins of tourism!

In other words diversity attracts – albeit diversity with mutual acceptance and respect for each other’s diversity. Whether a return to the currencies assumed by countries severely affected the Sovereign Debt Crisis (prior to their usage of the Euro) would even boost tourism levels to greater levels (than is the case at present) in these countries, constitutes another topic for discussion.

ii) **Common Objectives and a Shared Sense of Purpose**

Similar passions, common interests, sharing the same goals, visions, dreams and aspirations, constitutes a second and even deeper element towards the fulfilment of an enduring and symbiotic relationship.

iii) **Developing and Sustaining a Deep Sense of Understanding, Improved Communication Over the Years**

The approach to, and success in handling crises will depend on the level of understanding – as well as communication which has developed between those parties over the years.

Crises – be they financial, sovereign debt related, should ideally, provide a forum or fora whereby greater cooperation and collaboration between neighbours and global counterparts can be fostered: between financial and other related sectors from which such crises emanate.

iv) **Differences on the One Hand, Similar and Common Goals and Objectives on the Other, and a Balancing Reinforcing Complementary Symbiotic Relationship Which Not Only Generates Productive Results, But Also Brings Out the Best From Parties Involved in the Relationship**

“Excessive private or public consumption, or both, usually accompanied and enabled by rising debt and inflated asset prices, and a corresponding decline in investment, constitute a new set of growth models with built in structural limitations, which has recently been discovered by many advanced countries. Such a set of growth models appears to work until domestic aggregate demand can no longer sustain growth and employment – at which point it ends in either gradual stagnation or a violent financial and economic crisis.”³ Furthermore, “the opposite model”, according to Spence, that is, “the excessive reliance on investment to generate aggregate demand, is also a self limiting growth pattern. When the private and social returns of investment diminish too much, growth cannot be sustained indefinitely, even though rising investment rates can sustain aggregate demand for a while.”

Is There Always (and Should There Be) a “Constant” Leader in Successful and Lasting Relationship?

It is clear that all desired and required qualities for a collaboration and union cannot/should not be supplied from one source. To what degree is the other willing to

3 M Spence, “Why Do Economies Stop Growing?” Thursday 24 May 2012
<www.businessdayonline.com>

accept and be subordinate to the other's terms? Such leadership role should be understood and clearly underlined right from the inception of the relationship between both/all the parties. Where there is mutual respect between parties, this should not even raise serious issues. There is always an "implied" and clear/natural leader in every successful relationship – one who does not need to be announced. The chemistry between the parties says it all. However, certain higher profile public and global roles call for clear accentuation of leadership responsibilities and roles.

v. **Trust**

Will/Should the ECB terminate the provision of its facilities where and when it is evident that the bailouts which have been provided have proved ineffective or that the use of such facilities have been inappropriately/ineffectively used by its recipients? This constitutes one of those areas where the beauty of an enduring relationship arises. Depending on the relationship and parties involved, to what extent, and should terms between certain parties to a contractual relationship be relaxed (at all)?

This is a question which may be best left to the parties (who understand each other best) to respond to. There are not so permissible and irreparable breaches of contractual terms on the one hand, whilst understandable, pardonable and forgiveable acts also exist on the other hand. Where certain parties are so dependent on each other in a relationship, it is so difficult or inconceivable to imagine a breach of trust arising or occurring (and if it should occur, such strong dependency should outweigh the need to penalise each other (or the other party) unduly).

As highlighted in a previous paper, "with respect to the ongoing sovereign debt crisis, it appears more likely that bailouts will continue to be provided and that sovereign debt levels will continue to rise – given tough and austere fiscal measures operating in countries who have received bailouts. Given these circumstances, it becomes much

easier to appreciate why these countries are likely to default on their sovereign debt obligations.”⁴

In such a case as the above, should the ECB be expected to be more lenient and understanding of the tough fiscal conditions encountered by those countries being granted bail outs? The response to this would appear to be in the affirmative.

C. Conclusion

Trust is an element whose qualities are derived from the long term, consistent, consolidating, reliable and enduring nature of the relationship. Do factors such as historical background, past records and the predictability of future events (based solely on the past) constitute a sound basis for developing (and encouraging) rewarding relationships?

One thing is certain: the world is constantly evolving and there are evident signals to corroborate the fact that even past and present alliances are now forming and forging productive relationships with new and emerging alliances. The world has moved on! (that is, excepting those who choose to continue to dwell in the shadows of the past). Whether we rely heavily on, have invested in, or expect great returns from certain relationships, *the shades from the past should not blind our vision for the present and the future.*

More importantly, lessons from the past should serve as a forum for greater unity rather than a basis for the reawakening of old wounds. The International Monetary Fund serves as a classic reflection of the fact that beautiful and enduring relationships do not have to restrict themselves to just national or regional boundaries. This is evidenced by its present collaboration with the ECB in the sovereign debt crisis.

4 For further information on this, see M Ojo, “Bailouts and Longer Term Refinancing Operations: When Temporary Cures Generate Longer Term Economic” RePeC and SSRN papers.

National and regions unions are certainly of immense importance though. International unions and collaborations represent a huge step forward in solving crises which are increasingly of an international, global and systemic nature.

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