

## DEBT CRISIS AND THE INHERENT INSTABILITY OF THE SYSTEM

### Introductory thoughts on the current situation

The idea that the system of market economy is stable in principle and that its balance is always restored after temporary failures has been questionable already since 1940s when John Maynard Keynes published his demand-driven conception. The neoclassical paradigms<sup>1</sup> which became popular later, in 1970s and were based on such notions as *homo oeconomicus*, full market transparency of economic agents<sup>2</sup> and efficient and stable financial markets, have become a complete nonsense since the start of the financial and debt crisis. In the current globalised economy, the Adam Smith's much-praised concept of *invisible hand* is no longer something which would be guided by just morals and reasonable policies; instead, self-interested actions of single economic agents cause consequences which are far from being blessings for the society in general. Behavioural economics can offer a more realistic orientation here. For sustained efficiency of the market – i.e. a system based on freedom – it is necessary to establish reliable rules of the game and also abide by them. These rules will have to stop money markets and capital markets from becoming independent at frantic speed and causing destructive crises. The system of market economy assumes the principle of inseparability of liability from opportunities and risks. The perceived importance of banks and other financial institutions for the functioning of the system must not reduce the role of national governments to being objects of extortion which leads to a situation where private economy earns the profit and the society as a whole bears the losses.

Now that there are no longer exchange rates in the euro zone that could be used for the strengthening of the competitiveness of the countries that are in a crisis situation, the reduction of salaries (i.e. internal devaluation) is recommended to such countries as a proven measure to energise their national economy. Decrease in labour costs would allow the enterprises of these countries to offer their products at lower prices both in the internal and external markets, which would help to increase exports and reduce imports. The growing positive balance of trade could be used to reduce the foreign debt. The improved creditworthiness of such countries would reduce their refinancing costs and thus also the interest expenses on investments. As a result, this would stimulate the economic growth of the countries in debt. – So much about the theoretical considerations and the resulting recommendations.

Developments in countries that are in crisis have demonstrated that any decrease in prices achieved by reducing labour costs is hardly noticeable. Even if profits increase, they are not used for investments but for the repayment of debts. The situation is made even more problematic by the decrease in private demand due to lower income and the resulting further decrease in production – together with the

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<sup>1</sup> These have been promoted above all by the Chicago School of Economics and its leading thinker Milton Friedman.

<sup>2</sup> Who would always be able to gather important information and use it according to the situation for the adoption of effective economic decisions.

respective impacts on labour markets – which in its turn will lead to a new decrease in income. While imports also decrease, it has only an insignificant effect on the balance of trade on the background of the declining global business outlooks. Thus a strictly limited salary policy is not expected to have a significant effect on the increase in foreign trade.

It would be easy to solve the current difficulties by following the recommendations of the American Nobelist Paul Krugman<sup>3</sup>: national expenditures should just be increased à la Keynes and the resulting increased economic growth would make it possible to solve employment problems in the medium term – or at least in the longer term – and eventually also the debt problems. Economic growth is undeniably an important consolidation factor without which all efforts to achieve savings would be in vain. But the solution is certainly not so easy as Krugman imagines it! How to find funds for additional expenditures in a situation of a huge debt burden? Most countries which have fallen to the verge of a deep recession struggling with their dismal budget, e.g. the southern EU Member States, find themselves in a situation where their total debt has exceeded the limit they can bear<sup>4</sup>. It will not be possible to cover additional expenditure with more debts.

Recommendations to increase expenditures by financing them with debts do not take into account the rating agencies dominating the market whose influence has by now increased to the level which often sets the whole system at risk.<sup>5</sup> If the debt level of a country increases, the risk of reduction of the credit rating rises to the horizon as a threatening cloud. This has dramatic consequences to the country as the credit spreads for refinanced debts increase on financial markets and increase the burden on the state budget even more. Besides, many funds and insurance companies are allowed to buy only premium government bonds according to their statutes, and banks evaluate securities on the basis of market prices according to their balance sheet rules, and according to the decisions of the Basel Committee of the Bank of International Settlements (BIS) they have to provide equity-based guarantees to manage these risks.<sup>6</sup> With a decrease in the credit rating of countries also the quality of their existing loans decreases. This in its turn leads to increasing offering of these bonds on after-markets and a decrease in these bond rates (increasing profits) which may lead to another reduction of the ratings. Such developments are supported by „rules of legitimate expectations“ typical of market economy. As a consequence, countries in debt fall increasingly deeper into the debt trap.

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<sup>3</sup> Krugman, P., *End this Depression Now!* W.W. Norton & Company, New York/London, April 2012; ders.: *The Return of Depression Economics and the Crisis of 2008*, W.W. Norton & Company, New York/London, September 2008.

<sup>4</sup> What does *sustainability* mean in this context? Government debt position is *sustainable* if the capacity of the national economy of the country allows to expect an ability to make payments of interest and principal amounts also in the future. This in its turn assumes the respective international competitiveness.

<sup>5</sup> In that respect we can mention the three major US rating agencies Fitch Ratings, Moody's and Standard & Poor's.

<sup>6</sup> Basel II and in the future Basel III.

To avoid misunderstandings, though – rating agencies are an important factor for financial markets. Their evaluations not only discipline governments in following their budgets and corporations in business management but also improve – provided the ratings are correct<sup>7</sup> – market transparency for investors. However, considering the recent bad experience it would be absolutely necessary to thoroughly reform the rating agencies and establish strict rules. First of all, the two following principles should be applied:

- 1) Evaluation of creditworthiness by rating agencies is based on numerous indicators with variable degrees of weightiness which make them difficult to understand from outside. Therefore the agencies should have the obligation to disclose the bases for their decisions.
- 2) Rating agencies have to be responsible for their decisions. This means that if an inadequate decision by a rating agency can be attributed to gross negligence or even intent, the agency has to be at least partly liable or in the case of microeconomic<sup>8</sup> ratings even fully liable.

Economic growth has been recognised to be an important consolidation factor. However, economic growth cannot be the only solution to debt problems as the required stimulating national expenditures have to be also financed in some way. Considering the partly huge debt burdens of the countries in crisis the cost-cutting measures should be seen as inevitable. Also special problems arise from this as expenditures for the financing of the social sphere constitute a lion's share of national and local budgets. Cutting costs in this sphere is consequently inevitable, no matter how difficult it is to justify them from social and ethical aspects due to their relation to redistribution policy. We should note here that this does not mean dismantling of the social sphere but cutting public expenditures as exaggerated goals and wishes related to redistribution policy have led to unbalanced results. Here we could mention above all social benefits paid to people with a high income level: e.g. payment of child benefits to families whose total income exceeds a certain limit should be completely stopped and these limits should be flexible. On the other hand, raising the general retirement age is problematic and not well-considered when we compare, for instance, the capacity for work of a factory worker or road worker and a professor of an establishment of higher education. Tying the further raising of the retirement age to changes in the average age of the population seems less thought-provoking, though. There is still some potential for savings in the case of subsidies, such as agricultural support, salaries on the higher levels of public services and reimbursement of the expenses of the members of parliament, and also expenditures on weapons and excessive bureaucracy could be reduced<sup>9</sup>.

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<sup>7</sup> Here not only the macroeconomic indicators of single countries should be critically reviewed but also their political and socio-economic indicators.

<sup>8</sup> In order to avoid conflicts of interest, companies should be required to change regularly, e.g. every three or five years the rating agencies they have selected and to whom they pay for their services.

<sup>9</sup> Cf among other things – also bearing in mind a possible increase in public revenues: *Schuldenkrise in der Europäischen Union – Gedanken zur gegenwärtigen Problematik*, Estnische Gespräche über Wirtschaftspolitik, 2012, Vol. I, pp. 9 – 20.

However, comprehensive cutting of costs which is required in countries in crisis due to their high debt burden is still not enough to relieve them from the debt problems. The insufficiently considered austerity policy will rather even aggravate the problems as it may slow down the economic growth and increase unemployment. Therefore a well-balanced combination of austerity and growth policies is the only conceivable way out from the current debt crisis. This assumes starting fundamental structural reforms<sup>10</sup> which are appropriate for strengthening the economic growth. The following aspects should be considered:

- Industrialisation: countries with a well-developed services sector and a strong financial sector<sup>11</sup> seemed to have a powerful growth potential before the beginning of the crisis. Experience from recent years, however, has demonstrated that the services sphere is not so crucial as the degree of industrialisation as intangible goods have just a secondary role in global trade. On the other hand, measures which strengthen the production of goods have a general effect of increasing exports and therefore also promote economic growth. It is consequently extremely important to increase the creation of industrial value and thus also the proportion of economic sectors which produce goods in the gross domestic product.
- Investments to increase the productiveness of infrastructure.
- Measures to strengthen competition by removing barriers from entering markets.
- Labour markets reforms which assume breaking conventional structures. Labour legislation which protects labour should be adjusted to changes in economy and in the society. Two aspects are important here: on the one hand, medium-sized enterprises and industry should be relieved from the chains of labour law – to the extent it is socio-politically justified and feasible – to allow them some necessary space for adjustment to the constantly changing framework conditions of international competition. On the other hand, in parallel to long-time employees whose jobs are well protected by labour law, we have to think about young people with little work experience who are desperately looking for training places or jobs. These young people have currently fallen victims of the financial and economic crisis to an extremely worrying extent. When we observe the labour markets which have been split up like that it becomes evident that it is absolutely necessary to find socially acceptable compromises.
- Unemployment among young people should be fought above all through cross-border counselling and mediation of training places and jobs, by offering also pan-European language and professional study programmes, also recognition of certificates of education and professional certificates, which would help to remove barriers from studies or careers. Because it is certain: young people with education and training which conform to the current requirements have the potential for economic growth also in the future.
- Reorganisation of social systems according to the challenges of globalisation and demographic development.

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<sup>10</sup> Which will take time, however – approximately five years.

<sup>11</sup> E.g. the United Kingdom.

- Simplification of taxation systems; relentless combating of tax fraud by taking discouraging measures; the half-hearted and patchy system of double taxation agreements should be replaced with a single EU agreement to eliminate tax havens at least within Europe.
- Constitutions should include the concept of debt brake in order to reach balanced „structural state budgets“ in medium term<sup>12</sup>. If such rules are temporarily or recurrently violated, these obligations will have to be combined with (established) sanctions. All this is necessary, bearing in mind one basic truth: financial stability is an important precondition for sustainable economic growth.
- Creation of efficient administrative structures; relieving of medium-sized enterprises and industry from bureaucratic chains.
- Development of renewable energy sources and new technologies for the purpose of environment-friendly energy production, such as nuclear fusion<sup>13</sup>.
- Investments in efficient cross-border traffic and energy networks.
- Investments in education, considering also that professional qualification requirements have to be clearly defined. Progress-oriented research and innovative development activities are the foundation for sustainable economic growth.

At different times it has been the function of the banking sector to provide services for loan transactions in the interests of the functioning of the whole economy. Thus, on the one hand, banks have to gather liquid funds that are temporarily not needed, in order to direct them, on the other hand, to economic agents who need funds for investments or major private purchases. In parallel there is also which is called investment banking. This is nowadays an equally important area of banking for the whole system if we bear in mind supporting corporate financing through capital markets. Such cases are mergers and acquisitions, financing of projects (structured finance), share and bond issues (capital markets), capital investments for clients (asset management) and after-market transactions (sales and trading).

On the other hand, principal investments of investment banks and particularly the activities of shadow banking<sup>14</sup> more broadly often set the whole system at risk. Pure principal investments do not benefit the national economy in any way as the investors are not interested in real economy but on the profit margin of the capital owned by the bank. If the extremely speculative financial transactions of such credit institutions have led them to the verge of a breakdown, they are saved – according to current experience – from bankruptcy due to their importance to the whole system, so-to-say, with the help from the government, i.e. taxpayers. Normal companies have to declare themselves insolvent if their management decisions have had bad or too risky and are therefore no longer solvent. Banks are saved by the state,

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<sup>12</sup> State budget without the impact of the economic cycle.

<sup>13</sup> Not nuclear fission!

<sup>14</sup> Such as hedge funds, private equity funds, conduits, structured investment vehicles and certain forms of single-purpose companies.

however.<sup>15</sup> Thus the principles of market economy have been declared invalid in market economy.

It will not be sufficient to separate depositing and loan transactions and bank transfers from investment banking in the future (system of separated banks), to require from banks a higher equity capital quota for loan transactions, to require from banks the creation of an interbank risk fund with their respective contributions, and to impose a tax on them for transactions performed on financial markets. In the future, derivative financial instruments (in short: derivatives) will have to be monitored more strictly and systematically. This applies above all to over-the-counter derivatives (OTC) which have acquired astounding proportions by now. It still has to be considered thoroughly whether the different types of financial transactions have to take place only on the stock exchange. Financial instruments offered irresponsibly, i.e. purely speculative derivatives, such as short selling, have to be strictly prohibited.<sup>16</sup> Such sales take very important productive capital out of real economy and have proven to create confusion in the securities market and thus to increase risks for the whole system.

Not the state but the responsible owners of banks should be liable for the debts which banks cannot repay. This means in particular that shareholders should transfer their shares to creditors who will exchange their claims for the shares (debt-equity swaps). If debts exceed the equity of a particular bank, it is the creditors who have to bear the losses and not taxpayers.

Collective and unlimited greed<sup>17</sup>, planned large-scale fraud and also unbridled speculations should be definitely stopped in the financial markets which have lost touch with reality. Otherwise, private capitalist systems carry within themselves the same germs of failure as models of state capitalism. At the age of globalisation, responsibility and reason have to lead to also international recognition of regulation principles and their implementation by the governments in the whole world.

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<sup>15</sup> Such state protection has been so attractive in the past that it has among other things motivated numerous mergers and takeovers in the financial sector.

<sup>16</sup> This does not include derivatives which function as risk guarantees for actually performed solid transactions and are intended to level out fluctuations in e.g. prices of raw materials or exchange rates in the form of transactions for definite terms. The same applies to derivatives used for insurance against credit risks (credit default swaps, CDS).

<sup>17</sup> What did Friedrich Nietzsche say? "Where money rings, the harlot rules."