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Statement of the Shadow Financial Regulatory Committee on

A Regulatory Blueprint for Mismanaging the Sovereign Debt Crisis

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The exposure of the European banks to the sovereign debt of certain European countries has intensified the current financial crisis in Europe. As a byproduct of this crisis (and to a degree, S&P's downgrade of United States debt during the past summer), government officials in Europe were unhappy with the judgments of the markets about the creditworthiness of some governments. Consequently, they have put in place policies that undercut the markets for sovereign debt in a variety of important ways, potentially amplifying the risks in these markets and the ability of governments over the long-term to meet their funding needs. Given the absence of effective limits on the issuance of sovereign debt, it is especially important that governments respect the role of markets in pricing their debt.

While credit rating firms evaluate the creditworthiness of governments, to a degree governments also regulate the rating organizations. This conflict of interest makes the interaction between sovereigns and the rating firms especially delicate. Because rating agencies provide valuable information and perspective, it is important for governments to take rating agency feedback seriously. Instead, in August 2011, the Italian police raided a rating agency after an adverse action concerning Italy, and the U.S. Treasury declared that Standard and Poor's had exercised "terrible judgment" in the aftermath of its downgrade of the United States. This political intimidation tends to reduce the objectivity of rating agencies.

The ban on short sales of financial instruments and on naked credit default swap (CDS) contracts in some European counties also reduced the credibility and reliability of these markets. Indeed, short sales and naked CDS purchasers benefit investors by allowing the expression of negative viewpoints on sovereign debt and ensuring that these assets are not overpriced, an important form of investor protection. The viability of CDS instruments as a hedging mechanism has been further undercut by the efforts in Europe to treat the default in Greece as “voluntary” and not a credit event under the CDS contract. Ultimately, this policy damages the sovereign debt markets; the inability of investors to buy truly effective protection against default in the underlying credit will reduce the willingness of investors to hold sovereign debt in the future. This encourages worried investors to sell the underlying exposures—transferring the price impact from the CDS to the primary market. It also will increase the risk premium that governments will have to pay on that debt.

Meanwhile, the European Union’s (EU) application of Basel bank capital rules have placed a “zero risk weight” on EU sovereign debt, as if these instruments were not subject to credit risk, creating huge artificial incentives for banks to hold these sovereign credits. Obviously, such rules are not motivated by protecting investors, but arguably instead to increase the demand for holding these debt instruments and ease with which incumbent office holders can continue to issue them. This is not surprising, given that government officials designed the Basel regulatory regime.

A striking recent development has been the extensive purchases of European sovereign debt by the European Central Bank (ECB) in an attempt to buoy the prices of these bonds. As the marginal purchaser, the ECB determines their prices, and thus is manipulating pricing. ECB purchases create a difficult signal extraction problem—how much is the ECB purchasing, and to what extent is the price signal distorted? If the ECB is successful in raising the prices of the sovereign debt, then private demand would fall—making it even more difficult for these countries to borrow from the private sector. (Ironically, the recent collapse of MF Global was a result of its effort to speculate on whether the ECB would continue to support the sovereign debt.) The lack of objective determination of prices discourages other private investors from buying these bonds. Of course, the ECB is not unique in this role; historically, central banks have often supported foreign exchange pricing and the Federal Reserve itself has purchased mortgages, changing the term structure of interest rates.

These and other hard-to-predict changes in policies are a source of systemic risk. Indeed, governments are creating problems for themselves by causing doubt about the reliability of markets. Government interference in markets reduces the government’s own access to funding by weakening the integrity of market pricing, impairing the reliability of hedging mechanisms and raising concerns about counterparty risk. Lack of adherence to prior rules and the failure of governments to follow predictable policies have the ironic effect of amplifying the sovereign crisis.