A Modest Proposal to Make the Sovereign Debt Crises Manageable: Turn the Light Off

Author: Roberto Tamborini (/blog/author/rtamborini) · June 29th, 2011 · Comments (1) (http://www.economonitor.com/blog/2011/06/a-modest-proposal-to-make-the-sovereign-debt-crises-manageable-turn-the-light-off/#idc-container)

Any paper, article, speech, thought about the ongoing sovereign debt crises in the EMU ought mandatorily begin with these premises. First, sovereign debt management of *almost all* developed Western countries will be the key problem in the world financial markets for many years to come. Second, in *almost all* cases the problem has been originated by the 2007-08 disaster of private finance. Third, any attempt to deal with single countries separately with a "business-as-usual" approach will amount to cutting the bough on which all are sitting.

Many uncompromised observers have long noticed that sovereign debt markets are operated by mostly the same financial entities (sometimes even the same persons) which actively managed to destroy themselves and the private financial systems of the Western hemisphere, and have been bailed out by the same public finances that they are now sentencing to death. In doing this, they are, as it were, assisted by the rating agencies (RAs). The RAs themselves have been part and parcel of the demolition of the private financial systems across the Western countries. Partly because of appalling technical deficiencies, partly because of misbehaviour of various sorts.

Leaving aside the horror movie that we have been forced to see in the last few years, the role of RAs has always been controversial. Some studies have shown that RAs' releases have an impact on market prices, others that RAs merely ratify market valuations. Theoretically, it is trivial that if the financial markets were efficient – the dogma of the pre-crisis era – RAs would be useless, that is to say their fat fees would be a waste of money *to the detriment* of market efficiency. In fact, in efficient financial markets everybody freely knows all what is to be known in order to price assets correctly and allocate resources optimally. Hence it is surprising that over the last thirty years the prophets of the "efficient market hypothesis" (EMH) have also supported an increasingly pervasive role of the RAs. The RAs' certification of tradable or pledgeable instruments has become mandatory not only in a wide array of private transactions (as is the case with CDOs) but also in order to have access to highly qualified markets such as those for interbank and central bank operations. So far it is apparent that the dramatic failure of RAs with CDOs and other instruments of mass destructions has not prompted their retrenchment .

RAs may indeed have a useful role to play if markets are not informationally efficient, which *must* be the case if any legitimate profit is to be extracted from costly investments in information discovery and dissemination (this proposition was proved in a fundamental paper by Sanford Grossman and Joe Stiglitz in 1980, which then disappeared from the preferred citation list of the efficiency prophets). However, when we are in the shifting sands of market inefficiencies, we should first carefully understand what efficiency problem(s) we are facing, and then what are the right corrective measures to be taken. RAs may not necessarily be the right one.

In the years of the high theory of markets (which ended about thirty years ago with the advent of the market prophets and talebans), the idea was that markets are an important social institution as they collect and disseminate private costly information which is dispersed in society at the individual or local level. The champion of this view was, of course, Friedrich von Hayek (1937, 1945), but also, just to name one, Kenneth Arrow. In this view, markets *ease* the efficient allocation of resources, not because everyone knows everything and solves complicated optimization problems, but exactly for the opposite reason. This was the root of Hayek's fierce opposition to central planning.

When information is heterogeneous and dispersed, and each economic agent acts upon what he/she knows individually, competitive prices reflect available information in the form of the aggregation of such information. This principle is most clearly seen in financial markets where the key information is the future payoff of an asset. If the traders of this asset believe that the fair rate of return is *r*%, then the current price of the asset equals the future payoff discounted by *r*. Hence the current price depends on 1) the market forecast of the future payoff of the asset, and 2) the market return rate that is used to discount it. In the Hayekian view (and many theoretical models have proved it) "market" means an average of individual forecasts, opinions, etc. Our contemporary believers in the market efficiency convey the idea of the *existence* of one single "true" future payoff and market discount rate which *are known and consistently used by all traders* (the so called "rational expectations hypothesis").

The problem is that the views of Hayek and of the contemporary believers not only entail a different philosophy of knowledge and markets, but also lead to different practical implications on the functioning of markets. In the Hayekian view the heterogeneity of information is a *prerequisite for market stability and convergence to equilibrium*. The contemporary believers do not like to investigate market processes (how markets discover, or do not discover, the price that equates demand and supply). They just focus on out-of-the-blue equilibrium since their scientific leaders have argued that studying out-of-equilibrium processes is not scientific. The drawback is that their view of efficiency implies, logically, no trades, so that it tells us what the market-clearing prices should be, but it does not tell us how the market gets there.

Think of any daily stock market session. Common practice says that price movements are smoother and may find a balance between demand and supply more easily to the extent that trades are "thick". In a "thin" market prices are too volatile. To have a thick market, we need many traders with different information, so that some of them want to sell and others want to buy. Of course, only one side in an exchange will turn out to be right when the true payoffs will materialize, but that is exactly how the market remunerates the better informed and incentivates people to invest in information. The argument that, therefore, only the best informed (those who know the truth) will survive does not go that far. The economic world is complex enough (in the scientific meaning of the word) so that nobody can ever know the truth (if any) and can conquer its monopoly. Hence winners and losers are not always the same (which, by the way, underpins the "democratic" idea of the market as a means to reshuffle wealth across society).

Can a Hayekian market be improved by injecting more information? Difficult to answer in general. I guess that Hayek would be suspicious of professional information sellers that do not engage in trading directly. Anyway, there are good reasons to be suspicious. First, how can we ascertain that these information sellers have genuine information? Genuine means that they neither sell a replica of what professional traders already know nor do they just add noise (in the sense of Shleifer and Summers, 1990). Second, market prices should be driven by true news that update previous information of traders. The approval of a reform plan by the Greek government, or its *officially certified* failure, is true news, while the periodical ratings by Moody's are just learned (?) *opinions*, and so are the press releases of Mr. Trichet, of Mr. Schauble or of the *Bild*. Third, there comes a critical point due to Keynes's deep understanding of financial market sentiments. There are circumstances in which traders lose confidence in their information and forecasts (this is "uncertainty" in Keynes's market theory).

In these circumstances the opinions of others gain weight, and may trigger the phenomenon that market psychologists call *herd behaviour.* A typical symptom of herd behaviour is that heterogeneous beliefs suddenly coagulate on a focal point, the market becomes thin, everyone wants to sell or buy, the price is pushed up or down with no limit.

A financial market, when it becomes Keynesian, resembles an efficient-information market except that asset prices, *if an equilibrium is found,* reflect the focal information followed by herd traders, which may be totally unrelated to the fundamental valuation of the assets. As shown by the so-called "second generation" of speculative attack models, these prophecies are self-fulfilling. Suppose that the informational shepherd leads the herd to agree that the probability of default on a certain sovereign debt is much higher: one-sided massive sales ensue, the debt price falls (the CDS soars), the spread opens up, servicing the debt becomes more costly, the probability of default is indeed increased.

If in *this* context we think of RAs, or other chattering authorities, or would-be authorities, two crucial questions arise. The first, already mentioned above, is whether they deliver genuine information or they just add noise. The second is that the boundary between market information and market *manipulation* is thin. Even more so if we consider that *obeying* the RAs opinions has been made *binding* by regulation for some classes of transactions recalled above. What is socially preferable then? A market where prices are smoothly driven by dispersed, heterogeneous private information or a market where prices violently react to *possibly noisy* public information?

Looking back at this year of madness in the management of the sovereign debt crises in the EMU, one can hardly get rid of the idea that a massive amount of noise has been thrown into the sovereign debts' market, and that the boundary of manipulation has occasionally been trespassed (e.g. with some "timely" releases of unwarranted downgradings or political declarations). In the case of Greece, each additional basis point above the German *Bund* means increasing Greece's political instability, the hardship imposed onto the Greek citizens, and the costs of rescue packages funded by the other EMU countries and institutions. Moreover, undue collateral damages are persistently created by merely talking down the valuation of other sovereign debts in the area with hardly detectable connections with fundamentals. Hence my modest proposal: *turn the light off*, *please.*

Hawks of "small government" should convince themselves that downsizing public finances in the Western countries will be a long lasting endeavour. Any hasty attempt at accelerating the process may lead to another systemic disaster, with no saviour left over this time. RAs should be muted. Institutional authorities should talk less and do more in order to devise a credible, long-term intervention strategy to restore and secure orderly refinancing conditions for government budgets. Then market traders should return to their daily job; rather than guessing and betting on the next RA's release, they should spend more resources and time in genuine information seeking, and try to elaborate sensible forecasts through the fog of uncertainty. Bad forecasters will be punished, good forecasters will be prized and will provide valuable information for political decision making (rather than the other way round).

References

Grossman S.J., Stiglitz J.E. (1980), "On the Impossibility of Informationally Efficient Markets", *American Economic Review*, vol. 72, pp.884-907.

Shleifer A., Summers L.H. (1990), "The Noise Trader Approach to Finance", *Journal of Economic Perspectives*, vol. 4, pp. 19-33.

von Hayek F.A. (1937), “Economics and Knowledge”, *Economica*, vol. 4.

von Hayek F.A. (1945), “The Use of Knowledge in Society”, *American Economic Review,* vol. 35.

Filed under: Europe (http://www.economonitor.com/category/monitors/europe-monitor/)

Comment (1)

(http://ckckckc.com) Unlock blackberry (http://ckckckc.com) · *9 weeks ago (#IDComment171346206)* 0

Have you ever considered adding more videos to your blog posts to keep the readers more entertained? I mean I just read through the entire article of yours and it was quite good but since I'm more of a visual learner,I found that to be more helpful well let me know how it turns out! I love what you guys are always up too. Such clever work and reporting! Keep up the great works guys I've added you guys to my blogroll. This is a great article thanks for sharing this informative information.. I will visit your blog regularly for some latest post.