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Sovereign Debt Crisis

The New Normal and the Newly Poor

Dimitris N. Chorafas

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macmillan

First published 2011 by
PALGRAVE MACMILLAN

Palgrave Macmillan in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan in the US is a division of St Martin’s Press LLC, 175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

ISBN 978–0–230–29840–8

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

A catalog record for this book is available from the Library of Congress.

10 9 8 7 6 5 4 3 2 1
20 19 18 17 16 15 14 13 12 11

Printed and bound in Great Britain by
CPI Antony Rowe, Chippenham and Eastbourne

A slave is he who cannot speak his thought.

Euripides

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Preface

The history of economics and finance is littered with the debris of once-sacred theories. The 'new economy', whose promise of wealth and prosperity was supposed to be the only possible course, is now in shambles. The belief that theoreticians know so well how to manage the economy that crises are banned forever is another fallen idol. And the hypothesis that leveraging rescues people, companies and states from an existence of limited dimensions proved to be an unmitigated disaster:

This book is about *sovereign debt*, *fiscal deficits*, the *newly poor* and the deceit of the 'State Supermarket', with its *endowments* and cradle-to-grave care. The issues confronting the global economy – and most particularly America, Europe and Japan – are inseparable from the current lack of social and political leadership as well as of a credible plan to deal with the mountains of debt amassed by sovereigns, households and companies, particularly banks.

The text is written for people who need to know what the problem is with the mountains of public debt, families' deep indebtedness and financial institutions superleverage. It is not written for economists, analysts and other technicians of the 'dismal science', to use John Maynard Keynes' words. The many practical examples which it includes expose the situation by which western society has cornered itself. Its constructive criticism gives advice on how to come up from under, even if this means slaughtering:

- unaffordable endowments,
- unwarranted government rescues, and
- other proliferating but unsustainable big-spending projects.

Largely due to weak governance, the United States and European Union fell on parlous days. Public confidence is lost. Breaking trust can be done very quickly; re-establishing it can take a long time. The aim of this book is to provide an adult conversation on the risks of losing sight of past failures and our society's ability to solve its problems, with debt heading the list.

Nowadays, with all liabilities taken into account, for every \$1 of assets there is \$4 of debt. It is pure folly to think that such a huge amount of debt will disappear on its own, or even be partially repaid if current policies continue to prevail. Liabilities have the nasty habit of increasing with time, particularly when people and companies have lost their individual initiative and put all their hopes for the future in rescues by leviathan sovereigns.

Western sovereigns are struggling with colossal debt. Peacetime precedents are lacking, the difficulties are so great and the debt hydra so fertile that those supposed to know better are approaching the most vital issues in ignorance. Certainty about the right thing to do in this most challenging economic and financial situation is only expressed by people who either dwell in a world of fantasy or do anything that hits their fancy, while the economy around them falls apart.

'We are living with an unsustainable hangout between our commitments and our resources,' said Timothy Geithner, US Treasury secretary on October 13, 2010 in a Charlie Rose interview broadcast by Bloomberg News. Geithner evidently knows what he is talking about because, together with the Federal Reserve, the Treasury has become the big banks' safety net and universal fire brigade.

This is by no means a US phenomenon. Signs of distress are easily seen all over the global economic landscape, but most particularly in the western countries. From entitlements to the salvage of bankrupt institutions, the State Supermarket – a creation of infantile leftism – has taken on responsibilities which are unaffordable. Critics are right when they say that the biggest deficit the West has is in the fact that there is not enough leadership around, and also those who govern either don't know how or don't care to help the common citizen understand what the issues are.

Yet, in a democracy the people have the right to know why the economic and financial conditions are so grim, what has engineered the most recent deterioration and what kind of measures are needed to prune the system and put it on a growth course; also, why the sovereign debt is on an explosive path and what the next act of the drama will be if nothing radical is done to bend the curve. Which leads to three other questions: what lies behind the evolving economic environment known as the '*new normal*' (Chapter 1) and who are the 'new poor' (Chapter 2), and how can this trend be stopped before it becomes irresponsible?

The book the reader has to hand examines these issues and explains why nothing has changed so far – in spite of the deep economic and financial crisis created by big banks through gambling with novel (and little understood) novel financial instruments. The gamblers continue their good work; the regulators are timid; and this means that conflicts of interest have not stopped running down the state's finances.

On June 25, 2010 CNBC, the financial network, revealed that derivatives trades by American banks alone stood at 90 times the level of US gross domestic product (GDP). This was no number picked out of a hat. A couple of weeks earlier, a combined estimate of exposure by the US Senate and House of Representatives had put the market valuation of existing derivatives contracts at $1.2 quadrillion.

* * *

Unprecedented sovereign debt in peacetime and a quadrillion in derivatives is bad news for the economy of the USA, the EU and the global economy as well. Ultimately economies advance because their institutions are strong. Today they are on the sick list while governments are running after the facts, doing what Montagu Norman, the governor of the Bank of England in the 1920s and 1930s said about the central bank action which preceded the First Great Depression: 'We collected money from a lot of poor devils and gave it to the four winds.'

As the case of Ireland and of its 'Anglo-Toxic' Bank (Anglo-Irish) documents, the mismanagement of credit institutions and poor governance of sovereigns strongly correlate. High risk, descent into the abyss and a fire brigade approach is the course typically taken by the 'unable', who have been asked by other incapables to do the unnecessary.

Like the First Great Depression, the economic and financial crisis in which we are living – probably on our way to the Second Great Depression – has not been an act of God. It is the direct outcome of dismal governance by chiefs of state, monetary policy-makers, investment bankers and the common man in the street. In terms of cause and effect, some of the worst decisions date back to the 1990s, while others saw the light in the first decade of this century. The people who took these decisions:

- were singularly unqualified to be at the helm of great nations and of their central banks,
- could not decide by themselves on what to do and therefore consulted others who had conflicts of interest, and
- giving in to social pressure, they crash-landed the western economies through high leverage and unpayable debt.

Against all logic, large and complex banking groups (LCBGs) have been offered, since late 2008, an unlimited line of credit by sovereigns, at taxpayers' expense. But the LCBGs' wounds, due to their high gearing and misdirected decisions, have been so deep that their financial performance did not strengthen. Whatever money they got from central banks they used to bolster their capital rather than lend.

In spite of trillions thrown at the problem, the American, British, euroland and Japanese economies remained anemic. The result of throwing trillions to the four winds was a disaster. Credit is the oxygen of business activity, but sovereigns did not oblige banks that benefited from public money to extend credit. Without credit companies cannot function, and this has become also true of households. *If* banks cannot or will not lend, *then* the economy is falling off a cliff.

It is wrong to believe that central banks can continue forever accumulating useless collateral while printing money non-stop. The Federal Reserve, Bank of England and the European Central Bank (ECB) have been doing so for more than a couple of years, but it cannot become permanent. Mid-November 2010 the ECB indicated that there were limits to the short-term assistance it could give to Ireland's banks, which account for around a quarter of the total liquidity offered by the ECB to all eurozone banks. The same applies to Portuguese, Spanish and other banks.

Things got out of hand because there is a *symbiosis in debt* characterizing relations between big banks and sovereigns. This is creating serious risks for the longer-term sustainability of public finances. Together with entitlements, it sees to it that efforts associated to the reduction of government debt are half-baked. Tightening the belt has been always unpopular, and politicians think of their re-election when deciding about measures that need to be taken, forgetting that when the crisis becomes longer term toughness is required as well as competence, and that the party that deserves to win must craft a narrative and policy that creates opportunity out of disappointment and chaos.

* * *

The book divides into four parts. Part I brings to the reader's attention the financial risks which have been piling up for nearly 30 years, as well as their aftermath. It outlines the succession of errors which has lead to a situation known as the *new normal*, the economic, financial and social conditions which (by all likelihood) will characterize the next two decades.

The text brings the reader's attention to the fact that western societies are no more the globe's wealthy inhabitants. Their overleveraging and poor growth prospects have turned them into *new poor*, while less developing economies are moving up the ladder at a fast pace – aiming to be the new rich.

Part II provides documentation on the loose monetary and fiscal policies in the West, those followed over too many years on both sides of the North Atlantic. In recent times, such misdirected decisions were first made by Japan in the early 1990s, and they brought the former industrial dynamo to a state of coma. Hence, the term 'Japanification', describing where America, Britain and continental Europe are heading.

This thesis is supported by both qualitative and quantitative evidence. It is proper to inform the reader that in using statistics to document statements being made emphasis has been placed on accuracy and not on precision. It has been a deliberate choice to employ only the two or three most significant digits of numbers and ratios (depending on the issue) with emphasis placed on trend and on order of magnitude.

The theme of Part III is case studies in economic failure, starting with euroland's lack of success in financial integration, as well as its reasons. This is followed by a discussion on what went wrong in the case of Greece. Germany, France, Britain, Ireland and the so-called 'Club Med' provide some other interesting examples on how economies are being managed by sovereigns.

By way of conclusion, Part IV brings to the reader's attention the *new normal*'s effect on the western economies – including the one which used to be the most vibrant: the United States. Several financial analysts said that Greece is like Bear Stearns, the investment bank whose failure preceded Lehman Brothers' bankruptcy. By late November 2010 Ireland became Bear Stearns 'bis'. In search of a candidate for the Lehman role, some experts mentioned America, while others said Britain.

* * *

What we forget today is to learn lessons from history – economic, financial, political and social. *If* we don't understand what has been behind the successes and failures of our predecessors, *then* we condemn ourselves to repeat the same mistakes. Decisions leading to misdirected risks are often taken as a result of misquoting and misinterpreting what people of better knowledge have said or done.

John Maynard Keynes, for example, is often used by leftist economists as the patriarch of big-spending policies by the State Supermarket. Apart from the fact that this is less than half true, Keynes had the power to express his opinions without compromises, and he is quoted as having said: 'When the capital development of a country becomes the byproduct of the activities of a casino, the job is likely to be ill-done.'

* * *

I am indebted to a long list of knowledgeable people, and of organizations, for their contribution to the research which made this book feasible; also to several senior executives and experts for constructive criticism during the preparation of the manuscript. Dr Heinrich Steinmann and Dr Nelson Mohler have been among the most important contributors.

Let me take this opportunity to thank Lisa von Fircks, for suggesting this project, Renee Takken, for seeing it all the way to publication, and Keith Povey and Joy Tucker for editing the manuscript. To Eva-Maria Binder goes the credit for compiling the research results, typing the text, compiling the index and making valuable suggestions.

DIMITRIS N. CHORAFAS

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Part I
Financial Risks Which Kept Piling Up

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1
The World's *New Normal* Economic System

Five forces promoting the next economic landscape

In the 'go-go' years which followed the 1994 crisis of debt instruments, Alan Greenspan, then chairman of the Federal Reserve, coined the term 'New Economy'. This he defined as defying the laws of gravity by producing more and more wealth, practically forever. We now know that such talk was a chimera, while the tandem of bubbles it produced in 2000 and 2007 were real. Their origin was not difficult to detect:

- a highly accommodating monetary policy,
- free reign to leverage and other excesses, and
- scant attention by supervisory authorities paid to watch over systemic risk.

These causes of economic and financial troubles tend to correlate among themselves, amplifying their impact. Therefore, the disaster which followed was not totally unexpected. One of the outstanding consequences of the major global downturn, which started in 2007 and whose effects are still widely seen, has been the enormous increase in government debt in western countries. Spending by sovereigns rose very rapidly to both keep alive big banks and other 'strategic' companies, some of which were zombies, and offset the contraction in private sector spending, as millions of households confronted unemployment as well as uncertainty about the future.[1]

In the USA the public deficit jumped from 2.8 per cent in 2007, first year of the most recent economic and banking crisis, to 11.2 per cent in 2009. In the EU government deficits varied widely: from over 14 per cent in Greece to a little less than that in Ireland, 11 per cent in Britain, 9 per cent in France and 6 per cent in Germany. The big spenders at the governments' ivory towers have had a ball – and that's anathema to public confidence.