Kocki's Productions

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The Dangerous Power of Hystery

Collective market movement is dangerous

Collective movements of fear and panic can have dramatic effects on spreads. The ECB's decision in mid-2012 to announce its support of the European bond markets – without limits if necessary – was the game changer in the eurozone crisis, taking away panic from investors who feared the end of the eurozone. Spreads came down dramatically during the second half of 2012. De Grauwe and Yuemei Ji have shown in a recent study[1] that the more bond rates went up during the „fear and panic" period, the more they came down after the ECB decision - even with deteriorating economic and credit fundamentals. For example, while the spreads declined, debt/GDP ratios continued to increase.

Market „sentiment" crowding out rational analysis

In an earlier note De Grauwe described the risk of a temporary mispricing of the market.[2] The global financial crisis has shown that financial markets tend to be driven by extreme sentiments, be it euphoria (before the global financial crisis) or panic (after the crisis), thereby often neglecting economic and credit fundamentals. This is very delicate in a monetary union where financial markets acquire great power.

No guidance for investors

It seems that investors and those who pretend to do services for them did not really check to what extent market fears were justified, whether they were generating „bad market pricing" and what options were left on the country and European level to get risks under control. It seems there was no such guidance for investors. The developments since the ECB's market support committment in mid-2012 show it would have been worthwhile to carefully look at these points in a balanced risk analysis. Instead, funding risk, based on „market sentiment change" and „contagion risk" dominated the fundamental credit discussion.

Confusion about euro crisis management

Admittedly, the sequence of actions of EU politicians to get a grip on the crisis was sometimes confusing and hard to understand. I heard a lot of complaints about the lack of game changing measures. However, the history of European integration demonstrates that it was naive to expect a big bang solution to the euro crisis. Instead, in the past, a crisis has often been at the heart of further European step-by-step integration – after long debates. Those who missed the big bang tended to be overly pessimistic on Europe, without caring about remaining options.

Underestimation of governments' willingness to defend the euro

I have long insisted that the ECB has the institutional power and the instruments to become a

1 Paul de Grauwe, Yuemei Ji: „More evidence that financial markets imposed excessive austerity in the eurozone", CEPS Commentary, 5 February 2013

2 Paul de Grauwe: Self-Fulfilling Crises in the Eurozone: An Empirical Test, June 2012

game changer if necessary. The European crisis management's initial focus on the prevention of *moral hazard* and the strict conditionality of financial support is not to be confounded with a lack of determination to do whatever is necessary at a certain point in time to protect the eurozone. Today we know that the ECB is ready to defend the euro (and, by the way , its own institutional existence!), and to act as a liquidity bridge under the condition that governments do their homework. The Italian case shows how efficient this arrangement has worked to reinstall market confidence – despite continuing political noise out of Italy.

Exposed Sovereigns pay a high price

Italy is a striking case where market spreads driven by fear reflected concerns about eurozone governance rather than Italy's credit fundamentals. On top of that, when investors were in the fear and panic mode, Italy has also paid a high price in terms of strong downgrades of its sovereign rating. This had probably made it even more challenging for Italy to keep funding costs affordable. In the heat of the Euro debt crisis important fundamental data had been simply neglected, such as the relatively solid ratios of medium to long term debt sustainability as calculated by the IMF[3]: In Italy, the primary surplus of the government budget, as well as the total public and private debt level or the long term pension system outlook compare favourably internationally, and some of the long term fiscal adjustment needs are substantially less than in the US or in Japan.

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One could say that temporary mispricing of markets will be corrected in the medium term so why should we care about it? The point is that even short term overshooting of government bond interest rates and spreads actually can have a strong influence on economic and fiscal policy decisions. Paul de Grauwe has shown that governments who experienced very high interest rates on their bonds were pushed into a liquidity crisis which forced them to introduce very severe austerity measures.[4] He finds a strong correlation between the size of the spread and the intensity of austerity measures introduced. As a consequence, it cannot be excluded that the timing and intensity of simultaneous austerity measures in Europe - which continue to weigh on growth and employment - may have been motivated by market hystery rather than by rational analysis.[5] I fear the same goes for the sovereign rating process which became a circular and dangerous amplifier at that time. In both cases one can only hope that a more rational, moderate and balanced approach will dominate in the future.

3 IMF, Fiscal Monitor 2012
4 Paul de Grauwe: „The Governance of a Fragile Eurozone", CEPS, 2011
5 Paul de Grauwe, Vuemei Ji, February 2013