Is There Such a Thing as a Risk-Free Asset?

Nicolas Véron discusses the global market turmoil, the spread of concern to France, and the disquieting impact in Europe of the US credit rating downgrade.

Edited transcript, recorded August 10, 2011 . *© Peterson Institute for International Economics.*

Steve Weisman: The global financial markets continue to rock and roll in reaction to every little new step in the economic news. Nicolas Veron, visiting fellow at the Peterson Institute for International Economics, brings his European and in particular French perspective to a subject that's puzzling everyone. This is Steve Weisman. Nicolas, what is going on?

Nicolas Veron: I think it's difficult at this point to see through the dust of the battle, if you want to use an old expression. I think we have to believe there are psychological factors at play in the marketplace. I don't think you can explain the turbulence of the last few days just by a change of anticipation in US growth or global growth, or a change of fiscal outlook for specific countries. I think something more fundamental and less analytical is at play, which is certainly related to the US downgrade. And certainly in the case of France, there is a direct connection between the US downgrade and what we're seeing today.

Steve Weisman: What we're seeing, just to interrupt, is new trouble with French banks.

Nicolas Veron: With French banks and, I think, with the French sovereign. One of the reasons why French banks are in trouble is not just that they hold Italian or Spanish debt. But it's also that their exposure to the French sovereign is very significant and there are doubts about the credit rating of France.

Also if some banks have problems, there is a big tradition of not letting banks fail in France, so that we'll add that to the liabilities of the French sovereign. Really the banking question and the sovereign question are interdependent in France, certainly as much as in any other eurozone country.

Markets are, you know, there's this sort of feeling among many investors that say, "The US is double A; how can France be triple A?" Well, there are good reasons to defend the triple A status of France, and there are many parameters on which the fiscal dynamics of France are better than the US fiscal dynamics as a matter of fact. But this is not necessarily the thing thought about by investors.

And if I had to identify the key psychological factor, it's not entirely new, but it's certainly accelerated by the loss of the triple A status of the US at least from a Standard & Poor's perspective, it's the fact that there no longer is a such a thing as a risk-free asset of reference.

There are assets that are not very risky, but the risk-free asset of reference was the US government debt. And it's no longer risk-free in the sense of its credit rating.

So I think this has just accelerated investors' thinking about their investment framework in a very general sense, and this is a loss of anchor that really is disturbing for the entire investment community.

Steve Weisman: And it's aggravated by the specific situation in Europe, though.

Nicolas Veron: Of course. Clearly some French banks have big exposures to southern European countries which themselves have been put into a problem category, most obviously Italy.

I mean you could argue the fiscal dynamics of Italy are not that bad, but clearly now it's firmly in the problem category. It's a problem country within the eurozone, and therefore the French exposure to Italy becomes a very significant issue.

Steve Weisman: Let me circle back to the Germans, who have argued that Greek and maybe other debts should be restructured. Would they be saying that now that they can see that the losses would have to be taken by French and German banks?

Nicolas Veron: The German stance on this has always been paradoxical -- to the extent that there was such a thing as a German stance, because there are different views in Germany of course. It's easy to make the arguments that actually a bailout of Greece without imposing losses on bondholders would have been more economical for the German taxpayer.

That said, basically, forcing the restructuring of Greek debt at this point – which is not a true restructuring, because it doesn't really bring Greece back to sovereignty – is not a winning proposition in terms of the overall impact.

But the political situation in Germany is what it is: the German government is making the calculations that this is the only way to get the legislation passed in parliament. So it has been driven, basically, by local political conservants and not by economic or financial analysis.

Steve Weisman: Let me interrupt you. Explain for the reader and listener how a restructuring would eventually be a cost paid by taxpayers.

Nicolas Veron: There is one very simple factor: it's that the ECB [European Central Bank] has said, "Okay, we'll continue to take collateral from Greek banks, even if their debt is restructured, but we need a protection of this collateral and a guarantee on this collateral," And this is given by the other Eurozone countries.

So just the conditions that the ECB has asked for, legitimately, for taking collateral from the Greek banks and therefore preventing a collapse of the Greek banking system, to continue to inject liquidity into the Greek banking system – this is very costly for German, French, and other taxpayers. And it is directly caused by the…

Steve Weisman: Guarantees.

Nicolas Veron: Yes, by the haircuts or by the imposition of a default situation on Greece, because the ECB wouldn't have had to ask for this protection if Greece was still basically meeting its financial commitments.

It's now actually a very simple calculation to make. But still I think if it's the same way as in the US, you have this very moral argument on debt and deficit and spending cuts, which are not necessarily based on an economic calculation, but more on a statement of principles by the Tea Party Movement, and others. You know, the government has to be trimmed down and this is the way to go, even if the economy suffers.

I think there's a bit of the same at play in the German public. Bond holders have to suffer because if they don't suffer it's just wrong. And this is in the category of beliefs rather than calculations and it's very difficult for politicians to address.

Steve Weisman: I think that's always the case. I saw a quote from Larry Summers, that the measures taken [in 2008-9] struck Americans as unacceptable morally, or in terms of social justice. You hear Ben Bernanke [chairman of the Fed] saying, "You don't let your neighbor's house burn down just because he was smoking in bed," But that argument doesn't seem to play in America, and I guess in Europe.

Nicolas Veron: This has been a feature in Germany for a long time. Where the current situation is, I believe, a game changer -- and we'll see what happens about France and others – is that the entire framework of the plans that were finalized three weeks ago on 21st July was predicated on France, together with Germany and some others, being rated triple A.

This is the core assumption that underpins the current framework with the European Financial Stabilization Facility [EFSF] and the rescues that have been granted to Ireland, Portugal, and Greece.

So, if France does lose its triple A status, it will have to provoke a very substantial rethink of the policy approach that has been taken so far by the eurozone. So a lot of things are at stake.

Steve Weisman: How so?

Nicolas Veron: Because the EFSF basically is based on the guarantee of strong member states, and you need a critical mass of strong member states to guarantee it.

Steve Weisman: It can't be just Germany.

Nicolas Veron: Yes, exactly. Germany alone is not sufficient. So at some point you will need to replace individual guarantees, given by member states, with joint and several guarantees of the entire eurozone set of countries, and this is completely different politically.

So it will accelerate the debate in Germany, and elsewhere, about how you are really creating a de facto federal framework at the euro level without corresponding political institutions.

From an American standpoint it's easy to call it "taxation without representation." This is, you know, the most disruptive political proposition there is, in a way.

I think we're set for significant turmoil -- not only in the financial markets, but also at the institutional level in the EU, because we really have fundamental questions asked from this market situation to the EU institutions on the way decisions are made and the way decision makers are held accountable to the public.

So it may be the case that the financial turmoil is addressed in a satisfactory way relatively soon, but I think these fundamental political questions will take a very long time to resolve.

Steve Weisman: You often hear that where this might be headed is the ECB "printing money." What dangers of the German nightmare, of just inflating one's way out of this turmoil?

Nicolas Veron: I think if the ECB prints money by buying government bonds on which it makes a loss, it will need to be recapitalized.

Steve Weisman: So that's where the taxpayers come in.

Nicolas Veron: Here the taxpayer exposure becomes obvious.

Steve Weisman: What a depressing conversation, but thanks Nicolas.

Nicolas Veron: Thanks, as usual, for having me Steve.