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Ex ante vs. *ex post*: two examples

Main idea

- It is a bad idea to keep financial markets guessing
- The right policy for governments is to make a clear pact with markets and stick to it
- Two examples:
  - Greece
  - Banking reform

Greece (1)

- When the euro and the ECB were created, it was made clear that a common currency and bonds issued in that common currency did not imply that European states were responsible for repaying each others' debt. This was the *ex ante* agreement.
- The markets either ignored that warning or felt that default was very unlikely. For ten years, the borrowing rates of all Euro countries were very close to each other.
- Their forecasts turned out to be incorrect.
- In financial markets, it is well accepted that investors who make incorrect forecasts loose money. That should have been the end of the story.

Greece (2)

- As Reinhart and Rogoff have amply demonstrated, recovery from excessive debt is in all cases slow and painful.
  - It is best to reschedule the debt and get it over with.
  - Since this was the *ex ante* agreement, there was no qualm to be had: given the size of its debt, Greece should have defaulted.
- Instead, European governments engaged in a rescue operation, justified by an alleged “domino effect”.
- As a result, the taxpayers of Europe paid what should have been the losses of the investors.
- This was a terrible error, which is irreversible:
  - Today, if someone in authority says that debt holders should pay, M. Trichet correctly points out that this only raises the cost of future debt and makes the situation worse
  - Greece will default anyway
- Nothing, except turmoil, will have been accomplished by behaving *ex post* not in accordance with the *ex ante* agreement.

Banking reform (1)

- Everyone agrees that governments are *de facto* providing an implicit guarantee/subsidy to banks: when they do not function, the whole economy goes down
- Banks covered by the guarantee enjoy a lower cost of capital
- The boundaries of that guarantee should be clearly set *ex ante*
- Such was the wisdom of the Glass-Steagall act separating investment banks from commercial banks: the guarantee covered banks engaging only in commercial activities (deposit taking and lending)
- Miraculously, Paul Volcker suggested a partial return to that set up
- That is not easy to implement (there should be a segregated inter-commercial bank money market), but completely indispensable
- We shall see in the Fall, how Congress will decide

Banking reform (2)

- What is done outside the U.S.?
  - Globally: Basel III and equity ratios
    - Definite but limited improvement: when a crisis strikes, equity ratios deteriorate precipitously anyway
      - (Warren Buffett: « You only find out who is swimming naked, when the tide goes out. »)
  - In Europe:
    - Stuck with the model of the Universal Bank
    - Limiting bonuses!
- Both of these are meaningless without a separation between what is covered by the guarantee and what is not:
  - For those activities not covered by the guarantee, on what grounds would the government mandate amount of debt?
  - For those activities not covered by the guarantee, on what grounds would the government mandate compensation?

Conclusion

Financial markets have to contend with several dimensions of uncertainty:

- State of the economy and the individual firms
- Market sentiment: the uncertainty created by other investors
- Regulatory uncertainty should be minimized
  - While contract is being elaborated, there has got to be some tugging and pulling
  - But the contract once established should be clear-cut: the scope of the banking guarantee implies separation into two banking sectors
  - Once in place should be adhered to: avoid vagaries of the Greek case