

Q&A

Sovereign Crisis Shows Need to Balance Between Sovereign, Other Debt



Santiago Carbo-Valverde, a professor of economics and finance at the University of Granada in Spain, told Dana Wilkie that regulators need to rethink the role of “risk-free” bank assets, because they are “no longer risk-free.”

Q: Could Basel III have prevented today’s problems in EU banks?

A: If Basel III had been implemented now, maybe European banks would have had higher levels of capital to deal with the troubles, but I don’t see how Basel III would have prevented European banks from buying sovereign debt securities. My impression is that Basel III still drives banks to buy sovereign-debt securities, because it’s considered a risk-free asset.

Q: Regulators have viewed sovereign debt as “safe.” What are the other options now?

A: We need to rethink the role of these risk-free assets, because now we know they are no longer risk-free. They were considered low-risk because they were backed by governments. Most of the sovereign debt securities were rated triple A until the debt problems started. I would say government bonds need to be looked at more carefully, because they are more widely used for both investment and liquidity purposes. They are key instruments in the financial system. I’m sure this crisis is going to bring about deep discussion about how these securities will be considered in the future.

Q: Can you suggest some safer instruments for banks to hold?

A: Theoretically, it is difficult to find something safer than sovereign

debt. Some sovereign debt still seems to be risk-free — such as German and Swiss government bonds. Only deposits in central banks seem to be safer than government debt and this is why we see many banks depositing increasing amounts of money at the ECB.

Q: Should there be a balance of sovereign and other debt?

A: Yes. Too much government debt in banks’ portfolios brought about the present sovereign debt crisis.

Q: The world is talking of regulatory measures to prevent crises. What more needs to be done?

A: Certainly we need more international coordination — particularly on issues related to large financial institutions, and I don’t just mean the banks. Money market funds, mutual funds, pension funds, hedge funds — these are big players and they move funding very quickly from one part of the world to another, from one market to another.

Q: Shouldn’t policy makers have realized that after the first recession, a government-linked recession would ensue and require some other kind of funding?

A: Financial markets in a globalized world work very fast, and it is difficult for politicians to keep pace with financial developments. Other types of funding would have been welcome, but this is easier to say now than it was two years ago.

Q: Does this second-round crisis suggest that adopting regulations is too slow a process to prevent banking crises?

A: It is a question of political risk and political sluggishness. In the U.S., you had a six-month period from the failure of Bear Stearns to the failure of Lehman to have done more. My impression is that the political reaction in the U.S was too slow. But maybe

at that time, it still wasn’t clear the scope of the sub-prime mess. In the EU, it is even more true that we’ve been slow to react. In the U.S., you have one government and one united economy, but we don’t have that in the EU. We still need to agree on many things among 27 parties.

Q: Is a central fiscal EU out of reach?

A: Centralization is a key aspect of the solution for Europe. The problem is, it will be very, very slow. So far, Europeans have integrated very little of their fiscal policies. It’s such a big change, and it means giving up so much sovereignty and power. We first need to reach an agreement among countries. Then you have to approve this agreement in every single country and every Parliament. And then you have to implement it. That will take time.

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