

# **Sovereign debt and the crisis in the Eurozone**

## **- Part 2 of 4**

### **Who are the lenders and what makes state bonds so interesting for them?**

The main lenders come from the financial industry. Banks, insurance companies and mutual funds buy the bonds of their own state or other states. The second major creditor group consists of other states or their central banks. The German state, Japan and China, for instance, have considerable holdings of U.S. Treasury bonds. Thirdly, states attempt to harness their own population to finance sovereign debt. With bonds tailored towards this clientele states encourage the people to grant the state credit for interest in return.

In the German budget debates of the '60s and '70s there were concerns that sovereign debt would lead to a "crowding-out effect". Banks would only have limited credit available and the money they lent to the state could not be lent to companies. Sovereign debt would therefore have a negative effect on the 'supply' of cheap credit to companies. But this worry was never too severe and governments always arrived at the conclusion that they had carefully considered the extent of new net debt and that it was so modest that companies would not feel the burden.

This concern at that point was already ideological. In the following, we want to explain that when banks grant states credit, this does not displace other investments. On the contrary, state bonds spur on the business of banks so that they can grant even larger volumes of credit to companies. The thesis is that banks need state bonds so that their business can properly flourish elsewhere. This is important to understand so as not to conceive the idea that banks fucked up when they allegedly invested so carelessly in state securities. Furthermore, when states contract debt, it is always also an economic policy to support their financial sectors. This again is important to understand so as not to simply accuse politicians of mistaken policy by providing the banking industry with state bonds.

### **The financial industry as creditor**

One reason to invest in state bonds is simply to make money. The money spent comes back in a few years, plus interest. To that extent, state bonds are compared with all other bonds, stocks and other debt obligations offered by companies. From this perspective, state bonds are attractive to the lender when they promise – compared with other investment opportunities – higher interest rates.

The second point of comparison of the many money-making opportunities lies in the relative certainty that the debt plus interest will be repaid. An absolute security does not exist, but as a rule of thumb one can say that the safer an investment the lower the interest. A loan to a small business might earn more interest than a loan to BMW but in case of the small company it may be much more uncertain the loan will be repaid. And in this regard sovereign debt has a special feature.

The state, as the monopolist on violence, is always the last solvent subject in its society: firstly, when in doubt, it may decide to raise as much taxes as required to pay the debt. Before the state defaults it could, due to its taxing authority, tax all citizens, businesses, banks, etc. in its society so that they default first. Secondly, the state itself is the issuer of that money, in which it contracted debt. The U.S. and the UK, for instance, may, in the last resort, simply issue the money they owe others. For Germany and Greece, in contrast, this is no longer as easy due to their participation in the Euro. This aspect will be relevant later on in connection with the explanation of the European sovereign debt crisis – but for now we want to leave this special case aside.

As the master over money and as the monopolist on violence, the state usually enjoys the highest solvency in comparison to companies, banks, etc., in its society. With solvency we mean the relative safety of a debtor to be able to pay back its loans and interest.

State bonds offer less interest than corporate bonds but, compared to the latter, they are relatively safer. This relative safety is necessary to the banking industry as a base for its more insecure investments. Before we go into this, an interim step is required.

## **The trade and valuation of bonds**

If an issuer of a debt instrument, i.e., an issuer of a bond or the debtor, has shown for some time that she is a reliable money-making machine by servicing debt and interest on time then these debt instruments are traded. Organised via the stock exchange or via telephone between financial institutions, debt is bought and sold prior to maturity.

Due to the possibility to be sold at any time, a debt is assigned a value. Without this possibility it would simply be like this: a bank has 1 million and gives it to the state. Now the state has that 1 million and spends it. The bank in return has a debt obligation, i.e., a promise of future payment, say, in 5 years. During these 5 years the bank does not have the 1 million any more, but just a piece of paper with a promise. After 5 years the bank gets its money back plus interest if the state is solvent.

However, if there is a trade of state bonds then this transaction presents itself differently in practice. A bank which gives away 1 million does not have the money but the promissory note. If this is traded the bank has the option to transfer this note into money at any time. The financial sector treats this option as an asset. The bank's balance sheet does not simply state: "We are poorer by 1 million – in 5 years this will change again" but instead it is more like "We have the promissory note now worth XXX".

This capitalisation to turn promises of payment into an asset of debt obligations turns these promises into "fictitious capital". Here we do not want to go into detail along which criteria these promissory notes bonds are evaluated, they can be found elsewhere.[1](#)

However, here we want to highlight three conditions for the trading of debt instruments.

First, the debtor must be known to be a money-maker. Bonds or shares of small companies are not traded because no one can size them up. Daimler Benz, on the other hand, is known to be a big, even a global player; its economic performance figures are continuously published and continuously robust. In case of states, too, it is known how potent the national economy is over which they reign.

Second, the debtor must have shown that it always pays debt plus interest on time. Not only is it necessary to prove to be a money-making machine, but also to show (potential) creditors that this machine works reliably for them. For example, in 2002 Argentina announced that it does not intend to repay its debt in full. Following this, the creditors grudgingly accepted a negotiation with Argentina over the diminished redemption of their bonds. With this step, which is now discussed under the name “haircut” for Greece, Argentina has freed itself from its debt burden. The consequence was that Argentina did not get any more credit from the financial industry. Argentina is considered an unreliable debtor since and there is no (large) trade of its bonds.

Third, the debtor must contract large quantities of debt for its bonds to be traded. This sounds paradoxical at first since the more one is in debt, one might think, the less likely it is to be able to service all debts. But if there are only a few bonds on the market then there are high fluctuations of their value. These fluctuations, however, have neither to do with the bonds’ interest nor the assumed (in)security that payment of interest occurs nor with the changing assessment of the quality of the debtor. Instead changes in supply and demand have strong effects on the bonds due to the scarcity of the traded debt instrument. If the absolute amount is highly limited, a slight increase in supply might cause a big drop in price. In the business of speculation on changes in value such notes are extremely profitable, but also loss-prone. They are so risky that not many companies want to build their business based on them. This in turn has an effect on their trading volume.

Only when many bonds are bought and sold every day will a bond holder have some assurance that changes in value are based on the estimated quality of the debtor. This certainty is not only relevant to current buyers and sellers. If debt acts as an asset for the banks, then the daily changes in value even affect those banks that simply want to hold these bonds at present and do not want to sell them just now. Only when the bonds are bought and sold daily en mass, is it worthwhile for the bulk of banks to invest in them and to hold on to them. This way, trading volume is created in circles demand for bonds is created by the demand for bonds that makes random fluctuations due to tight supply and demand negligible. But for that the debtor must issue enough promissory notes first.

## **The particular significance of sovereign debt to the banking business**

In order to understand sovereign debt (and thus also to grasp the crisis) it is important to comprehend the function that safe and therefore much-traded securities have in the banking business as well as their role in banks’ balance sheets.

First of all, one has to give up the idea that banks would only lend their own money out. The money Barclays or HSBC lend to companies, invest in equities or state bonds they borrow from society themselves. Banks are characterised by the fact that they are always both borrowers and lenders. That this is the case with all banks, and hence is the norm, can be deduced from the obligation for them to hold 9% of their investments as their own property or own capital. This means that 91% of the money they lent or invested they themselves borrowed from elsewhere.<sup>2</sup>

Banks, for instance, issue bonds themselves, i.e., they go into debt with other investors in order to lend this money to others. An easy way to get money is to offer citizens to set up current accounts with them. Using this example we want to explain the important role sovereign debt plays for banks.

Every worker, every civil servant, every company has an account with some private bank. At, e.g., Barclays there is a constant flow of wages, salaries and earnings of companies into various accounts. To some extent Barclays lends out this collected money. The cost of these accounts, such as interest or administrative expenses, are lower than the interest rate Barclays may charge when lending that money out. This way they are, as they say, in business.

However, somewhat annoyingly to Barclays is the fact that customers withdraw or transfer money from time to time. For that the bank always has to keep money as a reserve that it cannot lend out, i.e., a minimum amount of money must be present at all times. Sometimes more money is withdrawn by the customers, sometimes less. In theory, Barclays would have to keep enough money for the maximum case, i.e., the amount of money all the bank's customers have in their accounts. Yet again, this would be even more annoying if subsequently only the minimum is withdrawn. In retrospect, this money would have lain idle money the bank could have lent out to make money. Good bonds, which can be sold any time and, thus, can be converted into new money, offer an excellent solution for this distress. Hence, in practice, Barclays holds back only a minimum of money as a reserve, invests a portion in good, marketable bonds and the remaining money it lends out to companies for higher interest rates. Yet, if account holders do withdraw the maximum of money, the bank simply sells the good bonds, it is liquid immediately and, thus, it is able to pay out its customers. And in case the maximum is not needed (i.e., withdrawn) the money is not fallow but Barclays has lent the money out and, hence, can reap interest.

Good, i.e., at any time marketable, bonds give the above mentioned contradiction a passable form of development: banks can enter into interest-bearing transactions, thereby increase their money as capital, and at the same time have quasi-money as a reserve in case of claims against them.

This function reinforces itself: if bonds are treated as bank capital and bought because of it, one can be more certain that one can sell at any time. Thus, the better they serve this function.

Because sovereign debt is considered to be particularly safe and traded as such, one can find it in the balance sheet of every bank. Sovereign debt is particularly compelling for banks due to the special safety of the debtor as the monopolist on violence and master of money. Sovereign debt, thus, is both investment and liquidity.

This way, the banking business is de-limited and freed through good, solid debt instruments. They are a good basis to take on extended credit and to grant credit and, thereby, to remain constantly liquid. This way the economically desirable 'supply' of companies with credit becomes looser and interest rates do not necessarily skyrocket because of a tight money supply (even though they might still do that for other reasons).

The question why states contract debt instead of simply printing the money they need derives a different answer than the usual one in this light: through its sovereign debt the state supports the national banking industry. Not in the way that it simply wants to pay for its interest, as many leftist critics of unjust redistribution assume. Instead, the state adjusts its financing to the requirements of the banking industry and this way contributes to de-limited lending by banks to businesses.

Furthermore, the state engages with the private interest of banks in quasi-cash, which also bears interest for economic reasons and supports the banks through its economic policy, when it endows its debt with another feature: the central bank always accepts sovereign debt and returns fresh, new, real money to the banks. So the banks do not have to trade the debt securities among

themselves to get money. They can go directly to the central bank and receive real money for these bonds there.<sup>3</sup> This way the state supports the financial sector in its interest to lend money and to have liquidity at the same time and this way the state supports itself in its accumulation of debt. Here, too, the Euro construction has some particularities to which we will return when explaining the crisis.

## **Other states as creditors**

The reason why states buy sovereign debt of other states is similar to the above discussed interest of banks. But here the first concern is not interest. States want to hold foreign currency to hedge their own currency. Germany, Japan and China have always had an interest in Dollar reserves in order to tell the world: “When in doubt, we have more than our own currency in which we can pay. If for whatever reason there is doubt on our currency, we are still able to pay in another currency.” Yet, this is intended as a sort of alibi so as no one actually ever questions their currencies. Every modern currency needs its own bank hoard. Now in a second step, considerations about the rate of return come into play: “If we have to hold Dollars as a reserve then we can also take United States treasury bonds which also promise interest. Should we then need to tap the reserve, we can exchange these bonds into Dollars quickly – either on the market, or with the Federal Reserve.” This way then, these states also have both: a reserve that at the same time functions as capital, i.e., for the accumulation of money.

## **The population as creditor**

The third group of creditors for states is their own population. In Germany a special bond was specifically created for this group, the Federal Treasury note. The conditions of this note very clearly show Germany’s interest with this. First, one can buy it even for small amounts of about 100. This way every wage earner is invited to invest her savings in the state. Second, “Type A Federal Treasury” note interest increases the longer one holds on to it. These notes have a maturity of six years but they can be returned early; one then, however, collects the low interest rates of the initial phase only. If one holds on to these notes until they mature then one collects the higher interest rates of the final phase. “Type B Federal Treasury” notes only earn interest at the end of their seven-year term anyway. This ought to encourage citizens – unlike the banks – to hold on to these notes until they mature. If one then, thirdly, reinvests the principal sum plus the interest back into Federal Treasury notes then the whole thing is tax-exempt. Federal Treasury bonds may, fourth, be bought by citizens and non-profit organizations only, not by banks. Fifth, they may not be traded on the stock exchange. This way these notes are excluded from the evaluation as fictitious capital.

These Federal Treasury notes hence produce proceeds for the German state which are removed from the speculations of the banking industry. This contributes to trust in sovereign debt by banks and other states as creditors.

<sup>1</sup>For example, see Karl Marx’s *Capital: Volume 3*, pages 594-600 of the Penguin edition. Also, our text “Gentrification” in this issue discusses capitalisation of land.

<sup>2</sup>On 27 October 2011 the Euro countries introduced new regulation for all European banks which raised the limit to these numbers. Before, banks only had to own 4% of the money they lent or invested – apart from a few exceptions.

3Technically, this can work in two ways. Before the introduction of the Euro private banks in Germany could sell state bonds to the German central bank (discount rate) or temporarily deposit them with it (Lombard rate). Since the introduction of the Euro, banks have only been allowed to temporarily deposit the sovereign debt to get fresh money. They must take these state bonds back after some time and return the money. But because private banks can do this over and over again, this procedure effects the same, namely, that the European Central Bank permanently holds state bonds and that the banks permanently have fresh money. In the current crisis, however, the ECB too has begun to directly buy state bonds.