The Germans restore fear [1]

Written by **Jan Boucek** [2] | Monday 29 November 2010

Once again, it?s those Germans displaying good common sense in the post-financial crisis world. Legislation is now being put together there to ensure bank bondholders take losses when a bank fails, rather than the state. In other words, no government bail outs.

Of course, the devil will be in the detail and the wider EU has a good record of ignoring inconvenient rules. However, the principle is absolutely sound. In a market economy, private investors are best placed to judge the rate of return they need to undertake a given degree of risk. Somewhere along the line in recent history, those investors judged their own risks to be minimal - not without justification.

In the US, Fannie Mae and Freddie Mac created an aura of a riskless housing market. Here in the UK, Gordon Brown said he?d eliminated boom and bust. Major banks around the world were understood, correctly as it turned out, to be too big too fail. Central bank lending rates were lower than justified by any rational measure of risk.

So the money poured into the apparently riskless banks who, in turn, could afford to make riskier loans at inappropriate interest rates. To be sure, the banks shamelessly exploited this opportunity with ever more complex, ill-judged and even shady packaging and re-packaging of debt but their actions were completely rational in an environment that was seemingly bereft of any direct risk.

What the German move does is restore fear to the traditional investment equation of fear and greed, the only two emotions in financial markets. While others natter on about schemes to control greedy bankers, the fastest way to whip them into line is by scaring the hell out of them ? with their own money.
The transition from the old order to the new will be tricky and painful but the destination is a good one ? investments made on the basis of all the risks involved and with no prospect of being saved from a bad call. As a consequence, bond yields will rise, as they should, but the process should favour investment in the most productive ventures, not those whose risks are mitigated by government or central bank intervention of one kind or another.
Such an approach could even work when it comes to sovereign debt. The only reason Greece, Ireland, Portugal or any other country need to be bailed out is because their bondholders assumed they would never lose their money - again, correctly as it?s turning out.

Despite their misjudgements before the financial crisis, markets are still pretty good at identifying risk before anyone else. It was the markets that realized Greece, Ireland et al were in way over their heads before any government or central bank did. Such calls would have come even sooner if their bondholders fully understood they could lose all their money.

blog comments powered by Disqus [4]

Source URL: http://www.adamsmith.org/blog/tax-and-economy/the-germans-restore-fear

Links:
[1] http://www.adamsmith.org/blog/tax-and-economy/the-germans-restore-fear
[2] http://www.adamsmith.org/taxonomy/term/5819
[3] http://disqus.com/?ref_noscript
[4] http://disqus.com