SHORT TERM SOLUTIONS FOR THE FINANCIAL CRISIS

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Abstract

The focus is on short-term solutions for the current financial crisis which would cause as little total costs as possible and would help to preserve the EU. Solutions will be discussed for issues such as organisation of bonuses, debt redemptions and trust, role of insurers, and direct credits. Direct credits are still the most cost-effective measures for solving the financial crisis.

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1. Introduction

Central to the current article is a short-term solution for the crisis. On the one hand, the costs arising from the solution should be as low as possible but, on the other hand, they should be as high as necessary for the existing Eurozone. Due to the progress of the current crisis, it is essential to find solutions that will prevent the collapse of the Eurozone and which can still be paid at all. This aim is much harder to achieve than may be expected as there are many different factors involved which are partly related to each other. Therefore, many options are discussed and solutions are proposed. They will be rated according to how well they work to minimise the total costs of solving the financial crisis.

2. Short Term Solutions

2.1 Bonuses

When paying bonuses and calculating their amount, one needs to take their benchmarks into consideration. For instance, the share of one's own decisions in a gained profit is always a benchmark for paying a bonus to the employee of the respective company. Moreover, a bonus is related to the payment within a bank or in comparison to other top performers. Additionally, this can be the case within a branch or between related branches. Finally, a top performer's value is defined by the profit for the owners or, often, by the shareholders of the bank or the TBTF-institute, respectively.

Moreover, an increase in bonuses is always necessary in order to retain the trader or the top performer. This is especially true as, at a return of 10% - which is the long-term, on average attainable stock yield - in combination with the current flat rate withholding tax, it is possible to quit with a 14- or 15-fold annual net salary. When a return is higher than 10%, the period needed is even shorter. Therefore, the bank is forced to reward performance respectively in order to be able to retain their top performers.

This means that, along the same line of reasoning, also chair-people and chief executives will be rewarded annually with a salary increase of about 4% - depending on the level of the flat rate withholding tax and with an inflationary adjustment. This lower limit to a salary increase is also necessary if one wants to retain good personnel at a bank or other related institutions for longer than 12 years.

Therefore, it is generally not possible to reign in the incentive-issue resulting from adverse effects that originate from risky behaviour with respect to the payment of bonuses. However, the problem can be alleviated in a different way.

For instance, the issue of betrayal within a bank can be revealed with the help of whistleblowers.

It is generally known that large confrontations due to betrayal within a bank occur again and again. Therefore, the regulations and laws with respect to whistleblowers should be developed further. For example, bonuses could be partly used for the purpose of a timely prevention or limitation of the danger coming from risks or risk-positions. Such a system is supported by the fact that the desk-neighbour or the direct supervisor will always be best informed about a colleague's or employee's scheming. Consequently, enlarging and promoting the use of whistleblowers should pay off in general.

However, competition is a cost-minimising factor as well which should be seen as being more cost-minimising as compared to bonuses.

2.2 Setting a Trend

According to (Morris & Shin; 2012, 18), the issue of overrated assets only became known when the subprime crisis started in August 2007.

Recognising high risks too late can already trigger a crisis. Therefore, the ECB should always be alert and warn about potential risks. In case of doubt, it makes sense to have a more pessimistic attitude and to announce stronger and more frequent warnings. However, it needs to be ensured that the ECB's reputation and ability to make prognoses or to evaluate the situation is not affected too much. In case of an unobvious or not yet obvious underrating of risks which have not yet been recognised, the ECB should set a trend using a very careful and proportionate choice of wording in order to limit negative effects early enough until more clarity and unambiguity is reached concerning the correct evaluation of the risks.

However, in case of a market-anticipation during an already rolling crisis which turned out to be too pessimistic, adjusting the evaluation to be more optimistic is not possible anymore. For the current crisis, for instance, it could already be established that the attitude had been too pessimistic.

According to (Bi & Traum; 2012, 164), an agent expected an annualised default rate of 37.88% for Italy. However, the actual default probability only lies at 30% when the current annualised debt-to-GDP ratio is ranging between 1.46 and 1.60.

Therefore, the quality of the ratings can be improved when it is clear that the debt-to-GDP ratio in the size of its actual default from is deviating (considerably) from the default that is to be expected. This will automatically result in different credit ratings.

Furthermore, if ratings can be improved through this model – which is clearly indicated by the results –, then this should lead to better estimations for default-risks for states in the future.

If a too high default probability is given on the market, this should be made public and transparent so that the interest rates on government stocks decrease. Therefore, it should make sense to then set a trend in order to give rise to potentially lasting decreases in interest rates.

Furthermore, according to (Bi & Traum; 2012, 166), there are further factors which need to be investigated for the default risk which will then help to better understand the complexity of the evaluation with respect to the rating or the evaluation of the risk.

According to (Coenen et al.; 2012, 74f.), it is better to set a trend if it is at all possible in this area. For instance, this could be initiated by necessary reforms.

Moreover, following (Gros; 2010, 349) argumentation, it is dangerous when investors withdraw because they doubt if the EU can still solve the financial problems.

Therefore, it is necessary for the solvent countries, the ECB, and the IMF to clearly show that the financing problems of the less wealthy countries will be addressed with utter determination and that the TBTF-banks will not go bankrupt. Each insolvency of a TBTF-institute or of a defaulting country such as Spain or Italy would most likely cause conflagration which France could also fall prey to. In such a case, the financial possibilities would be exhausted for Germany. Therefore, apart from showing determination and energy, a trend needs to be set and signals for improvement need to be sent our repeatedly so that the situation will not spin out of control further and the markets will quickly gain confidence again.

According to (Gros & Alcidi; 2010, 7), the standardised "Happiness Index" illustrates that, from 1996 until December 2009, the attitude was extremely negative both in the US and in the Eurozone. Additionally, since the end of 2005, the attitude was much more positive in the EU compared to the US. However, this difference has levelled as of recently. Within the Eurozone it is noticeable that the population of Germany is still the most satisfied one. However, in France and Italy, the attitude is considerably more negative and in Spain it is extremely negative.

Therefore, a trend needs to be set so that the attitude can slowly improve and that the people can gain confidence. This will also positively affect consumer spending and, therefore, the overall economy.

In comparison to setting trends, Eurobonds are a more direct approach to solving the financial problems of some of the EU-countries. Therefore, they are regarded as being a more effective cost-minimising solution.

2.3 Time for Repaying Credits and Confidence

Following (Bi & Traum; 2012, 164f.) argumentation, the numbers for Greece and Italy also show that the debt-to-GDP ratio can stay the same and that the potential for a default can decrease (later on) anyway.

Therefore, it should be useful to grant the bankrupt countries enough time for repaying the credits and the funds they have received from other countries. When the deadline for repaying is early or set very tightly, high financial burdens for the population and, eventually, for the economy can occur. Furthermore, this can cause a higher risk for a default despite a decrease in the debt-to-GDP ratio. Therefore, the level of debt should be kept stable until the situation is alleviated entirely and the crisis is completely resolved. Moreover, the economy should be supported most effectively from the side of the government. Such an alleviation of the situation on the government bond-market can arise from the decrease of the risk of a default through a credit event. If the effect is large enough over time, then, the respective country will also be able to return to the financial market and fund itself again as well as repay debts to other countries.

According to (Gros; 2010, 348), the case of Dubai showed that the United Arab Emirates enforced both an extension of the period for repayment and a reduction of the interest rates that needed to be paid at the same time.

However, such a period for repayment should at least be 18 months plus a variable number of months as the markets usually anticipate the development for six or 12 months in advance, and sometimes up to 18 months in advance. This means that a period of time shorter than 18 months will not leave the defaulting countries with enough time to react appropriately to create positive effects for their own options for refinancing on the capital market However, in order to avoid creating adverse effects based on too low individual initiative of the respective country, the upper limit granted for repaying the debts should not be higher than about three years. This is also an important psychological signal not to beat down the debt burden by reducing the debt itself.

Furthermore, the confidence in the EU should not be destroyed by wrong policies.

According to (Gros & Alcidi; 2010, 1-10), it is important to create confidence when the attitude in the EU is extremely tense due to the current crisis. This is to prevent violent riots, mass demonstrations, or a bank run from occurring. If fear spreads because of violent riots, then the negative attitude will only get stronger. Moreover, frequent mass demonstrations would affect the economy negatively and can freeze important and necessary reforms which inhibit the growth in the intermediate term too much. Especially when the confidence in the banks and in the Euro as a currency is destroyed and panic arises, the resulting bank run would have serious consequences for the entire EU. Therefore, each member country of the EU should consider its options for improving the attitude at least within its own boundaries.

With respect to the required effort and the intrinsic value, it is also important to actively involve insurer and pension funds in securing the financing of the EU-countries.

2.4 Insurer

Insurer could be promoted in such a way that they redeploy in more investments for structurally weak areas of a country in their investment portfolios. Apart from security aspects, also the yield plays a major role in decisions for investment. For instance, investments could be guided indirectly from a governmental level by allowing for tax concessions.

Furthermore, abolishing a minimum interest return for the insurers may entail that the redeployment of defaulting countries within the EU to German federal bonds is stopped or reversed. As this concerns a four-digit billion amount, it is very important to have the insurers as well as the pension funds available for financing the defaulting EU-countries. Only when no yield has to be generated, the capital can be invested in slightly higher risks as can currently be seen for the Italian and Spanish government bonds for instance. However, the legally determined minimum interest return should also not be lower than 0% so that the alternative of doing nothing would not be the optimal one and that the appeal to seek profit with a maximisation of the profit is not overridden.

However, if the insurers do not redeploy to other government bonds, to German bonds, or to other asset classes within the Euro-currency, but, instead, turn towards the area of the US-dollar, then the Euro will be weakened. The corresponding positive effect of more exports due to a weaker currency and the better growth impulses should definitely be included in the tactical considerations for the insurers' strategic decisions.

A lower level of relative interest rates in the EU as compared to the USA would weaken the Euro and, therefore, entail currency gains apart from the reduced insurance charges for a currency-swap. This could convince insurers to redeploy money from the Eurozone to the US – for treasury bonds for instance. This would cause disadvantages for the liquidity in the EU-countries which are obvious from the deduction of the funds from their government bonds towards EU-foreign government bonds and the respective higher interest rates for their own bonds. Therefore, this would be counterproductive for financing the Eurozone.

However, the effect of an external subsidy as compared to the involvement of insurers and pension funds can lead to an even better cost-minimisation when the input is put into perspective to the result. From an absolute point of view it is possible that the financial support is moving through the level of deployments by the insurers.

2.5 Direct Credits

According to (Lacina & Rusek; 2012, 71-73), it is essential to consider which of the following two options would be the better one: (a) if a defaulting country remains in the EU or (b) if a defaulting country leaves the EU.

Nothing will be gained from a member-country leaving the EU. When the home-currency is reintroduced, apart from a de-valuation, an inflation would also occur and the debt burden in Euro would still have to be repaid. Furthermore, the banks would have a major problem both with the change in currency and with the debt burden. Moreover, the respective population's buying power would not be increased. Additionally, the danger of a bank run would emerge when the exit from the Euro would become more obvious which would have fatale consequences for all major banks of the respective country as well as for the EU in case of TBTF-banks. Moreover, the signal to the markets would be that the cohesion of the EU would not be given unconditionally anymore and domino-effects on other countries could appear. This would then lead to the breakdown of the entire EU and would certainly have serious consequences for the economy in the intermediate term as well as on the potential for refinancing in the EU in the long term. Therefore, it is necessary to find an appropriate way to minimise the costs and to inhibit future crises at the same time. At the moment, direct credits can still be provided to the defaulting countries by the solvent countries in order to enable their refinancing outside the financial markets.

According to (Bi & Traum; 2012, 164), the correlation between the level of national debt in Italy und its decennial development of interest rate lies at only 0.01. This correlation should be restorable based on Italy's large assets, its intact economy and contestability.

This lower correlation means that promoting the growth should be seen as paramount compared to repaying the debts. At the same time, the financial leeway for Italy's government bonds on the financial market is limited. For financing the country, funds should be granted from other countries to ensure the further progress of the current financial situation. However, reforms for promoting growth should be connected to this in order to gain the confidence of the financial markets and, furthermore, to provide the grounds for internal financing as soon as possible.

Moreover, a borrowing ceiling of the financial sector and, ultimately, the country's financing should be capped – which is also in favour of direct credits.

According to (Schularick & Taylor; 2012, 1057f.), the examination of over 140 years of historic data has shown that, the larger the financial sector is compared to the country, the more dangerous this will be for the respective country and the country will be more prone to crises. There are indications that booms and crashes in the stock market have significantly larger effects on the real economy of a country in which the financial sector is large. Therefore, they are especially counterproductive for the respective country. It has also been shown that past credit bubbles were the best single indicator for a country's future financial stability. Credits are advantageous for economic growth to a certain extent for a certain period of time. However, a strong increase in credits is a robust indicator for the predictability of a coming crisis. Therefore, it is possible to predict future developments from the past. However, it seems that financial crises would also cause a bad memory for future crises.

Therefore, limitations of credit volumes should be introduced that are relative to assets, to the economic size of the country, and to the size of the entire financial system. Then, an escalation which could trigger a large crisis should be prevented. Furthermore, nothing should be done in this financial crisis which would accept possible turbulences with respect to costs.

At the same time, an increase in the current public spending ratio would be useful.

According to (Welfens; 2011, 29), a public spending ration of 4.5% of the BIP is suggested. The national decision makers should transfer budget rights to the EU so that the EU in Brussels can decide on the use of the funds when the public spendings cross a certain threshold. Then, the interest in the policies made by the EU should increase considerably so that the increasing disinterest, which shows in the lack of election turnout for European general elections, could be stopped.

The current deficit limit of 3% which is posited in the Maastricht Treaty should be increased to 4.5%. The generated leeway should be especially used by solvent countries in order to support the other member-countries of the Eurozone which have large financial problems with their national budgets as well as financially supporting their growth possibilities through direct credits.

Furthermore, according to (Mabbett & Schelkle; 2010, 81-85), direct credits provided by solvent countries to the defaulting countries are more useful as long as they can be afforded financially.

The interest rate should orient itself on the expected inflation as a lower level for direct credits. Therefore, they should not be lower than 2%. Otherwise, the markets would not see any incentive for the EU-countries – especially Spain and Italy – to cut spendings and to promote growth if the debts could be repaid via inflation. Moreover, it makes sense to limit the upper level of the interest rate in order to keep it payable. This means that the interest rate should not significantly exceed 3% for the long term.

In case of too high risk estimations of the customers for government bonds, variable interest for government bonds should generally be capped with an upper limit as well in order to allow for the further financing of a country. Moreover, the funds which have to be used for paying the interest rates cannot be used for economic impulses anymore which will cause the weakening of a countries' solvency due to a weaker economic growth. This would be counterproductive for the buyers of government bonds.

As an incentive for repaying earlier, the interest rate could be reduced so that positive effects for the main creditors such as Germany could occur. Moreover, the interest rate can be variable in order to support the aim of returning to the capital market earlier. According to the credit volume, this could also be handled differently depending on individual cases of EU-countries so that the correct incentive-threshold can be met as precisely as possible for the respective intensity of the efforts and to develop an optimal effect on the creditor.

So the most cost-efficient measures which can contribute most effectively to solving the current financial crisis in the short term are bilateral credits in form of direct credits. Due to extreme distortions on the market, Germany has to register a historic low for interest rates on government bonds. This money which had been redeployed by market participants needs to be directed back into the defaulting countries. This is currently the most cost-effective measure as long as the market players do not force a potential collapse of the Eurozone too much and assume it predominantly. Moreover, limitations from constitutional courts should not complicate direct credits too much or prevent them entirely. In such a case, Eurobonds are the best alternative for a short-term solution. Additionally, it is also important to promote growth in many ways in order to release the EU-countries from financial distress. To refinance themselves, to fund themselves through higher fiscal revenue, and to be able to install necessary reforms, they need to regain unlimited access to the financial markets.

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