Fiscal Deficits and Financial "Innovations"

It hardly needs to be stated that the safety and sanctity of sovereign debt is the underpinning of the entire debt market in a country. One of the "benefits" to developing countries of a liberal capital account was supposed to be that bond traders employed by investment banks, by shorting the bonds in global markets, would "discipline" spendthrift and irresponsible governments: to quote Renu Kohli, ex-IMF, for example, "*the pressure of a liberalized capital account is imposing policy discipline.*" (Mint, March 4, 2010). As is coming out in the Greek government's debt crisis, however, what the major investment banks seem to have done is to help Greece, and a few other countries, for several years, to reduce the reported outstanding debt and/or fiscal deficit, through the use of derivatives or "financial engineering" as it is called. (More recently, however, they are shorting the debt by using credit default swaps: no wonder, the French and German authorities and the Chairman of the Federal Reserve are all considering whether net long. "naked" positions in credit default swaps, particularly on sovereign debt, need to be constrained.)

The financial instruments used to reduce the reported debt and/or fiscal deficit were of two types:

⇒ Cross currency swaps at off-market rates, leading to a reduction in the amount of the outstanding debt – of course at the cost of increasing the future debt servicing cost. In effect, the difference between today's exchange rate and the off-market rate at which the currency swap has been done, becomes an immediate cash inflow.

⇒ Securitization of future cash flows, like subsidies to be received from the European Union, highway and airport tolls and fees; etc. By securitising the future flows through a special purpose vehicle, in effect, the originator is receiving upfront the present value of the future receipts sold to the SPV. These receipts are treated as "sales", i.e. current income, and not borrowings. Using this mechanism, current revenue was being inflated at the cost of future receipts.

The cost of such strategies is much more than plain vanilla sovereign bond yields. Fat fees are also earned by the structuring banks and the lawyers who do the documentation. The bank which has come in for considerable media comment about the currency swaps is Goldman Sachs, which has reportedly earned a few hundred million dollars in fees on the swaps. (Goldman sold the swaps to a Greek bank, a couple of years later.) Goldman itself has claimed on its website that "*these transactions were consistent with the Eurostat principles governing their use and application at the time."* Eurostat is the statistical office of the European Union. Its task is to provide the European Union with statistics at European level that enable comparisons between countries and regions.

While the transactions were surely within the letter of the relevant rules and regulations -- the lawyers and financial engineers would have ensured this --, the case also raises several other issues:

⇒ Did Eurostat clearly understand the implication of the transactions, viz. window dressing of the current number at the cost of future fiscal deficits, by using off-market rates, or did these get buried in the complexity of documentation?

⇒ There are serious question marks whether regulators would allow such practices in corporate accounts. I recall that, some years back, the license of one of the subsidiaries of UBS to operate in Japan was cancelled by the authorities, as it helped corporate clients to hide current losses, postponing them through the use of derivatives;

⇒ I also recall that Sumitomo (in the case involving huge losses on commodity derivatives) and some insurance companies (who had guaranteed the performance of certain commodity derivatives contracted by Enron subsidiaries) had challenged their liabilities, claiming that the transactions were really loans disguised as derivatives. If memory serves me right, both these matters got settled outside the court and the banks structuring the derivatives lost a lot of money.

In substance the Greek government transactions were not very different. The U.S. Federal Reserve and the Securities and Exchange Commission are now "*looking into a number of questions relating to Goldman Sachs and other companies and their* *derivatives arrangements with Greece*" (Ben Bernanke, quoted in Financial Times, February 26, 2010). Incidentally, U.S. authorities are also investigating some hedge funds' trades in the euro.

Last week, the Greek government announced measures aggregating $ 6.5 bn to cut spending – a cut in the entitlements of all public sector workers, including ministries, local governments, state organizations and Parliament; a reduction in government spending on public works projects, and a € 200 mn cut in spending on education --; and increase value added, fuel and the so-called "sin" taxes on cigarettes and alcohol. A luxury tax has also been introduced. The public sector workers are up in arms against the spending cuts, and the impact of tax increases remains a question mark, Greece being notorious for its "underground" economy. Financial market reaction has, however, been positive, with the euro strengthening in dollar terms midweek. Are Greece, and the euro, out of the woods? Keep your fingers crossed!

A.V.Rajwade
Email: avrajwade@gmail.com