Financial markets without a risk-free sovereign: Moderator's introduction

Harold James[1]

Thanks, Steve, it's a great pleasure to be here. The title for this session is "Financial markets without a risk-free sovereign". I think the problem with the clock,[2] as it were, is an ominous sign for this, because I think it's true we like to have an agreed reference framework. So the common system of time, the standardisation of time in the 19th century was one of the great stories. I like to have a number that I can think about when I know what the weather is going to be like, whether it's Fahrenheit or centigrade; in Switzerland you still find Réaumur, or you could even do things in Kelvin, but you like to have a number for the temperature.

It seems to me, in the same way, we like to have a number that can serve as a guidance point for the interest rate. If we look at very, very elementary, very crude economic text books, they will tell you that there is a point at which the demand and supply of credit interact at the interest rate. But when I'm looking at this historically and I ask students: Well, what exactly is the interest rate? It's absolutely impossible to say what that is.

Except at some moments, we think that we take one particular set of interest rates as a guide and use that as a reference framework. At lunch time, Steve was thinking about the Dutch bonds in the early 17th century, with an 8% yield. One of the stories of financial modernisation is the gradual lowering of interest rates in the 18th century, after the financial revolution in Britain. Just before the First World War, there was a kind of consensus that a standardised interest rate was really part of the basis of a civilised society, so that when General de Gaulle writes in his war memoirs, when he tries to describe what the France was like that he was growing up in that was then destroyed by the uncertainty of the Great War, he describes the characteristic of the era he grew up in as the era of 3%, "l'ère du 3%".

Looking at it in a broad framework, if I may just, as an introductory kind of comment, I think that in the 19th century, most people would take the Bank of England's bank rate as the guide for the whole international system; in the third quarter of the 20th century, probably the US Treasury bill rate. And that choice reflects the transition of the system from a fundamentally London-based, commercially based view, to a world in which government securities and the power of the United States are the keys to the international system. In the late 20th century I think probably, looking back, analysts would take Libor as the critical rate. But then we look back after the events of the last years and really have big doubts about this.

So first of all the question is: What's the basic guidance rate? Is there something like this? And related very much to this idea of having a risk-free interest rate, is that at all a credible idea? In Jaime's presentation this morning, he suggests that the consequence of not having such a basic guidance point is to produce a considerable amount of disturbance and uncertainty, and in a sense, that was

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2 [Editor's note: the digital clock in the conference room was temporarily stuck between minutes.]

actually what General de Gaulle was being nostalgic about when he said that before the First World War things were calculable and that in the 1920s they certainly weren't calculable any more.

The second framework for the issues we should look at, I think, this afternoon is the question of the corresponding collateral to this rate. What's a suitable form of collateral? Is there something that's risk-free enough to serve as collateral?

And that leads, I think, into a third area of discussion, and again it was adumbrated already this morning, about the sustainability of the fiscal position of big industrial countries. And Europeans often like to make this point, that the EU fiscal situation in aggregate looks better than that of the United States and much better than that of Japan. Is it conceivable, when you think of the developments of the last 15 years or so, since the Asian crisis, is it conceivable that because of their better fiscal position, the debt of large successful emerging markets could take the place of that of overburdened industrial countries? Those, I think, of all issues, those are potentially relevant to this session.

We have here the same kind of mixture as in previous panels, of so-called practitioners, policymakers, and academics, but actually the practitioners are very distinguished academics, and the policymakers are also people who have thought deeply about the implications and the whole story. And the academics, or the academic, in this case, is somebody who also came from the business world. So it's all mixed up; I think we can't use these guidelines as very suitable. We don't even have a guideline for the organisation of this discussion that's very appropriate.

First of all, Peter Fisher, please, from BlackRock.