Workshop on

Diverse Regional Responses to the Global Crisis

Implications for Finance and the Real Economy

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The current negative contribution by the EU to the global recovery is so evident that we need not spend time in showing data and charts.

There are no mysteries on why this is happening. I will try to summarise the argument in five points.

1 –**Fiscal rules**

The peculiar construction of the EU leaves fiscal powers at the national level, with coordination left to common national fiscal rules. The first and stronger reaction to the recent crisis has been to tighten the EU fiscal rules. They now require to quickly reach balanced structural fiscal budgets, but given the obligation to decrease in 20 years sovereign debts to a level not higher than 60% of GDP fiscal surpluses are in fact required. Furthermore, a new rule obliges public expenditure not to grow more than GDP. Let me be clear on one point: although stricter for the euro area, these fiscal rules embrace all the member countries of the Union.

This is clearly a deflationary and politically dangerous arrangement for the entire area. Investments and gains in productivity, i.e. the engines of growth, are the losers together with employment and social programmes. Increasingly counting on net exports for aggregate demand, the EU, the Euro Area in particular, is critically dependent on outside growth.

2 –**Fiscal self-defeating strategy**

One effect of the crisis was to push the sovereign debt of most EU member countries well above the statutory 60% of GDP. After the initial debate on the causal relation between sovereign debt and

growth promoted by the work of Reinhart and Rogoff, historical evidence has cumulated in favour of the causal direction from growth to debt. The EU fiscal rules, the so-called austerity measures, revert that historical nexus. This is a further proof that, as Keynes stressed, in economics few iron laws exist, with outcomes much depending on a mix of ideology, theories and politics. Austerity is a self-defeating strategy, because, despite low risk-free interest rates, the average cost of debt remains higher than the growth of nominal GDP and primary fiscal surpluses produce a loop of lower growth and higher debt.

The situation is worsened by the fact that very slow growth, high unemployment and labour market reforms (more on this in the next point) conjure to keep core inflation at the edge of deflation independently of currently low world energy prices. Because the effect of low inflation on nominal GDP is higher than on nominal interest rates, the self-defeating mechanism is strengthened. The classical way to alleviate debt positions by increasing inflation is barred.

3 – **Income distribution and structural reforms**

As a general tendency, since the 1980s the share of wages in GDP has significantly decreased. Because of the concomitant decrease of the investment share, and in the EU, of the limits to public expenditure, apart from exports, aggregate demand could only be pushed up by leveraging the household sector. Independently of distortions and bubbles, this process has a limit in the ability of households to serve the debt. New financial macro and micro prudential measures have recently reinstated stricter limits to liquidity constraints.

Physiologically, higher household debt and demand should go hand in hand with higher wages and employment. On the contrary, the persistence of high unemployment is strengthening the pressure by firms to decrease wages, with the menace of shifting investments elsewhere (they do it anyway) while fiscal rules goes contrary to increased employment. No wonder that household demand is stagnating.

What are the recipes that the EU is imposing on countries with fiscal budget problems for allowing them to breathe a bit? Structural reforms. It is true that the markets of many EU countries, Germany included, have diffused forms of rents, especially in the professional sector. But this is not what mainly bothers the EU. Its attention is focused on the labour market and on public expenditure and taxation.

The liberalisation of the labour market follows the usual lines, bringing the wage bargaining of trade unions at the firm level, permitting a larger dose of temporary labour contracts and making lay-offs easier. These reforms would not attract much opposition if it was happening in vibrant economies, where a person aged 50 could easily find another similar occupation, where the asymmetry of power proper of the labour market were contrasted by significant minimum wages, where governments pursue employment policies and adequate welfare schemes. The fact is that the EU economies are all but vibrant and the reforms adopted or in the pipeline are increasing the poverty rate.

Cuts in public expenditure are considered necessary for lowering taxes. The belief that Big Government puts a dynamic brake on the private components of aggregate demand is strengthened in Europe due to the share of public expenditure in GDP being higher than in many other countries. This is considered an anomaly. In general this anomaly has two dimensions: squandering and rent positions inside the public sector, and a large welfare state.

Although it is not always easy to distinguish between the two dimensions, from a policy standpoint we should not object to cut squandering and rent positions. We should expect, and are experiencing, objections from the beneficiaries of these positions, some of which are, however, legitimate if the welfare state does not cover the resulting increase in unemployment. In several European countries, a bloated public sector was part of the implicit social contract. Anyway, the positive effect of this spending review will be insignificant compared with the brake on aggregate demand produced by the constraint to reduce fiscal deficit and debt: not only social expenditure cannot make room for the effects of these cuts, but also taxes can be reduced only marginally. Apart from the Havelmo theorem, in the present situation households use the increases in their marginal income to repay debt or to increase precautionary savings and also to make room for lower public services because, as we will see in a moment, social benefits have been cut and continues to be cut. This is, for instance, the recent experience in Italy. Decreasing firms' taxes has similar results. With unchanged long-term expectations, firms are not going to invest more and, definitely, not in more labour-intensive techniques. This is what is happening in German Mittelstat firms.

In conditions of large unused capacity as the present ones, it is just stupid to create a deflationary spiral by starting from cuts in aggregate demand Interventions capable of producing social direness and unrest should come when conditions have improved. But this would require giving respite to troubled governments, helicoptering to them enough resources for implementing reforms.

The second dimension, reform of the welfare state, produces effects that are even more serious because they imply a re-design of the European social contract on ultra neo-liberal lines. Proponents of this regime-change affirm that savings in public expenditure will help to decrease taxes, and in turn help in spurring consumption and investments by households and firms. However, the fact is that the poorer section of our societies, now including a portion of what was the middle class, is the one that is going to suffer from lower health care, pensions and education. What has remained of social mobility will be lost and wealth and income distribution will become more uneven. These policies will be additional forces pushing towards long-term stagnation.

Considering that EU non-core countries have labour costs that are a fraction of the core ones, and that non-EU countries are also not constrained by the EU rule that prohibits state aids, the combined effect of the above reforms is at best very limited also in contrasting shifting abroad existing plants and new investments by national firms. Italy is again a good example. We have many innovative small and medium-sized firms that have no problem in paying high salaries for good workers and in paying due taxes. What they lament is the negative weight of the structural inefficiencies of the country on their efficiency and ability of prompt response.

4- **Political fights for ineffectual monetary policies**

In contrast to other central banks of advanced countries, the European Central Bank's (ECB) main transmission channel is through swaps with the banking system. The result is that the liquidity circulating in the economy and the ECB balance sheet, net of banks' deposits at the central bank, is critically endogenous, especially in the upward direction. Open market operations, as normally intended, are considered unconventional interventions.

Inside the ECB council, an important minority views the acquisition of private assets as transforming the ECB into a bad bank and the acquisition of sovereign bond, the only deep market for relevant interventions, as contravening the EU treaties. It is tragicomic that the judges of the European court of justice have a clearer idea on the necessary freedom of action of a central bank than some European central bankers. This minority position, which has so far weighed on the lagged response and limited interventions by the ECB, comes from a mix of neo-liberal fundamentalism and political de-integration of the Union.

The problem is that the critics of adopting QE in Europe may be right, although for the wrong reasons. QE is increasing political fragmentation in exchange for dubious results. Last Wednesday the board of the ECB decided unanimously that QE with the pari passu clause (same seniority of the other creditors) is a legal monetary instrument, decided at majority the beginning of QE next March, and decided with consensus that 20% of the losses coming from eventual debt restructuring will be shared while 80% will be borne by the national central bank of the restructuring country. Furthermore, the acquisition of sovereign bonds will be limited to 25% of each emission and 33% of the entire debt. Starting from next March, the ECB and national central banks will buy 60 billion euros per month, including in this amount the carry on of previous programmes concerning covered bonds, ABS and bonds of European agencies. The provisional end of QE is September 2016; it may be terminated earlier or renewed depending on whether the inflation target of 2%isreached or not.

As for risk sharing, the reality could be different from what the above numbers suggest. If we extrapolate the acquisitions made under the previous programmes, around 18 billion euros per month under the regime of full risk sharing, they already exceed the 20% threshold. The result is that each national central bank will bear all the risk of its own sovereign. Because the orthodox approach to central banking requires the government to recapitalise its central bank when the latter is subject to heavy losses, the entire restructuring process will become more costly for private creditors. In addition, opposition to risk sharing for public debt while not for supposedly high-grade private debt is a very bad signal that when the life-vest of the central bank is really needed it will not be there. The limit of 25% of each emission is explained by not wanting to reach the qualified minority necessary to block restructuring processes. Not explained is the other constraint, the 33% of total debt. We might suppose that the objection previously made by some members of the ECB board on including Greece in the QE programme has been covertly accepted since the Greek debt in the ECB balance already exceeds 33%. The entire QE programme thus represents a political compromise according to which the formal declaration of the legality of QE had to be tempered with the actual absence of risk sharing and the exclusion of the country for which a new debt restructuring is quite a certainty. I share the opinion that with this compromise the idea of having a European central bank is gone and the whole intervention will further fragment the European financial markets, with effects that will be the opposite of the intended ones.

As for the effects of QE, we know that it works through the price mechanism by lowering long-term interest rates and devaluing the currency. How far this will reverse the deflationary stance of the EU fiscal policy is more than debatable. Instead of QE, the ECB should helicopter the money to

national treasury departments, but in this case Germany would send the Luftwaffe to shoot down the helicopters. Without higher concomitant government expenditure, QE will mostly produce some portfolio adjustment between the central bank and financial intermediaries. But this also is far from certain because, as I explain in the next point, currently the constraint on banks, which are the European engine for credit, is not given by liquidity but by capital.

5- **Low capitalisation and profitability (ROA) of European banks**

Recently the ECB and the European Banking Authority operated a Comprehensive Assessment of the largest European banks (CA= asset quality review + stress test for the years 2014-2016). It was quite a distorted exercise. Commercial banking was hit harder than investment banking, so that, for instance, universal banks with huge amounts of level 3 derivatives (mainly OTC assets evaluated by banks' internal models) escaped large haircuts.

And we find other strange things. For example, Deutsche Bank, perhaps the structurally less profitable bank of the lot, passed the exercise having counted as extraordinary gains 3,500 billion euros in each of the three years of the stress test. How can they be extraordinary is a mystery because the same annual amount is present for the whole period; moreover, we were not given any hint on where these gains come from. The total amount of 10,500 billion euros represents the 20% of the current capitalisation of DB. Credit Agricole presents the same trick, although for a more modest amount of 4,500 billion euros.

The result is that many banks that we know are in a fragile position, many German Landesbanken included, passed the CA. If the ECB had utilised the net loss rate that the Fed applied to stress test large US banks, the result would have been a carnage. In addition, the exercise takes into account the gradual transition to the full application of Basel III capital and liquidity requirements (the so-called grandfathering), with the result that after 2016 many banks will have to add new capital. Few days ago, the ECB remembered that the capital game is not over. Then, how to recapitalise banks?

One of the features of the present international regulatory framework is that it is indifferent to the profitability of banks, as if there were always large cushions of fat to count on. Minsky correctly pointed out that one of the stability concerns of the Glass-Steagall Act was to give banks enough non-competitive profits. On an average, European banks structurally present a low profitability, less than half of US banks. The current and medium term state of the European economy produces a large dose of bad loans and therefore an even lower net profitability. In addition, Basel III and the

new recovery framework increase regulatory compliance costs. This on top of the fact that Basel III is confirming or reinforcing what Basel I.5 had already done, a shift from loans to less demanding activities in terms of regulatory requirements. Lower profits and lower leverage means lower potential growth of banks' assets. It is hard to believe that the capital market will be eager to capitalise year after year such structurally distressed banking system just to permit it to comply with regulatory standards.

The result is that it will be hard to convince banks to swap sovereign debt that they keep with zero risk weight in their banking book with fresh loans to the economy. The schizophrenia of the ECB is evident: its monetary committee wants banks to lend more while its supervisory committee wants them to hold more capital and more of liquid assets.

Conclusions

The problems of Europe come from mixing bad ideologies, bad economics and the absence of capable political leadership. The discussions that I had in the last few years with European political and social representatives convinced me that, regrettably, the problem is not just selfishness. It is a deeper-rooted mix of ideology, fear and ignorance that was strengthened by the recent crisis. (For example, try to explain why the German people have always kept much of their savings as bank deposits.)

Relevant political uncertainties and internal divides render the attempt to design future scenarios the work for magicians. However, just to stress the problems we face, let me play with a chaotic scenario and a low profile scenario.

If the forthcoming electoral results in Greece, Spain, France, and the UK, cause the existing political fragmentation to reach the point of rupture, to save face new institutional geometries will be adopted, apparently of a temporary nature for not going against the EU treaties, with the new dis-Union made up of different blocks. To bring the exercise on formal grounds, we could single out a set of relevant economic and social variables, apply to them a principal component analysis and finally, by means of a cluster analysis, obtain the optimum number of blocks and their composition. My fear is that the result will look like a stroboscopic leopard skin. Because there will be no common resources to manage first restructuring and then the new convergence, Soros will have a

new playground and the world would face a big boost of uncertainty, speculation, financial crises and beggar thy neighbour policies.

If the EU survives in the present shape, it will be because of a new political compromise that will go in the opposite direction to what is needed to strengthen the Union. Instead of centralising fiscal powers, the outcome will be the re-nationalisation of some of the powers previously devolved to the Union, a tendency that is already observable with the new EU authorities. The current EU motto, Unity in diversity, will become that of Managing diversity. The result will be more akin to a free trade area than to a political union. As is already observable in the British debate about exit, the probability of this scenario depends on cross-European economic interests reaching a compromise with parochial ones and populist sentiments. However, this political compromise would not deal with the basic institutional and economic problems that led to the current situation. Mixing re-nationalisation with the neo-liberal agenda will contribute to increase internal and external imbalances, systemic and institutional fragilities, thus making the chaotic scenario the more probable long-term result.

Contrary to what reason dictates, we could also envisage a more optimistic outcome, where the second scenario serves to buy time. To reverse the current anti-European sentiment, the EU should reassess the feeling that belonging to the Union is beneficial for everybody. How to do it in the present circumstances stripped of significant resources and without the invasion by benevolent aliens is beyond my capabilities. But sometimes history offers real black swans.

In any case, one message is clear: in the next years do not expect a positive contribution by the EU to the world recovery.

Thanks.