



EUROPEAN POLICYMAKERS ARE FOOLING THEMSELVES

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I. Introduction

Policymakers in Europe are fooling themselves. They are underestimating the nature of the economic and financial crisis while overestimating the importance of the policy response they have thus far been delivering.

II. Underestimating the crisis: ‘The goose with golden egg is gone’

Policymakers fail to see that the model of ‘asset bubble’ based growth, which was created over the past decade by Wall Street financial wizards, is in deep trouble. It is no longer possible to tempt private sector agents to take on more debt to keep spending. For several years to come, households, corporations and banks will be focusing instead on driving down their excessive debt loads by abstaining from spending and investing.

Unless policy succeeds in mobilising new drivers of demand to compensate for depressed private sector demand, the slowdown in economic activity will not be temporary. It is therefore futile, even dangerous to focus on early ‘exit’ strategies from fiscal expansionary action as the Commission is doing by already now triggering ‘excessive deficit’ strategies against certain countries. Such an approach is based on the erroneous assumption that the phenomenon of depressed growth will automatically come to pass after a few quarters. Whether we like it or not, the deleveraging process of private debt loads implies that high public deficits and indebtedness are here to stay for a long period to come.

III. Overestimating the policy response: The case of finance ministers

Meanwhile, and despite the fact that we are facing the worst crisis since the Great Depression, European policymakers are dangerously complacent.

Finance ministers reject the idea of adding more fiscal stimulus to the economy, arguing that Europe, in contrast with the US, has stronger unemployment benefit systems, higher public employment and outspoken redistributive tax policies. European economies are therefore thought to be self-stabilising, taking away the need to undertake discretionary fiscal policy action.

Unfortunately however, finance ministers ignore the fact that these systems of ‘automatic stabilisers’ have been seriously weakened. For more than a decade, finance ministers themselves have been driving structural reforms to weaken benefit systems, to cut public employment and to lower marginal tax rates for the highest income earners. This may have made European economies more ‘flexible’ but it has also reduced Europe’s capacity to withstand negative shocks. Finance ministers should therefore better think twice before discarding fiscal stimulus plans.

Moreover, finance ministers are confusing cause and consequence. The rapid rise in public deficits to levels of 6% to 8% of gross domestic product (GDP) for Italy, France and Germany, or even 10.5% of GDP for the UK (by 2010) is seen by finance ministers as reassuring: Automatic stabilisers are working to ensure recovery.

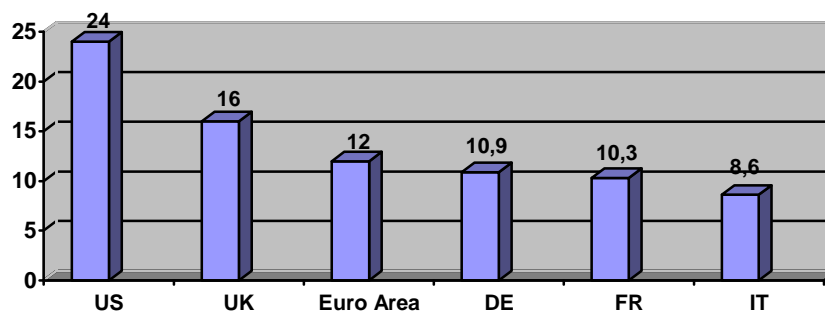
This is a major mistake. The spectacular rise in deficits is not reassuring at all but is extremely alarming. It is pointing to the fact that the crisis is hitting the real economy in a much, much harder way than was anticipated. And since ‘automatic stabilisers’ are only capable of cushioning at most half of negative shocks, this implies that the other half of a (gigantic) shock is still working its way through the economy, thereby inflicting enormous damage to investment and jobs.

Estimates recently released by the OECD¹ illustrate this. On the one hand, public deficits in the euro area are expected to increase by a cumulated 12% of GDP over the 2008-2010 period. (The fiscal effort of the US is, by the way, two times bigger, see graph). The euro area will nevertheless still be facing end 2010 a level of economic activity which is 8% of GDP lower than potential level. Mass unemployment will return with euro area unemployment rising from close to 7% in 2007 up to 12% at the end of 2010.

The financial crisis is squeezing our economies so hard that the shock remaining after the automatic stabilisers (plus some extra discretionary action) have been allowed to function is still devastating. The rise in public deficits is therefore anything but reassuring but should be seen as a warning that fiscal policy is actually loosing the battle against the forces of recession.

Here, it also needs to be stressed that confusing discretionary spending and automatic stabilisers will fail to overcome the deficit paradox: Both policies result in higher deficits. However, the discretionary fiscal stimulus is acting in a precautionary way and aims at stopping the perverse downwards spiral and keeping the automatic stabilisers from pushing up deficits so quickly and so high.

Cumulated fiscal policy effort over 2008-2010 compared to 2007



Source: OECD Interim Forecast March 2009, in % of GDP

IV. Overestimating the policy response: Monetary policy waiting too long

Meanwhile, the European Central Bank (ECB) is suffering from the same disease. European central bankers finely observe that the euro area interest rate in the overnight market is now much lower than the ECB's policy interest rate.

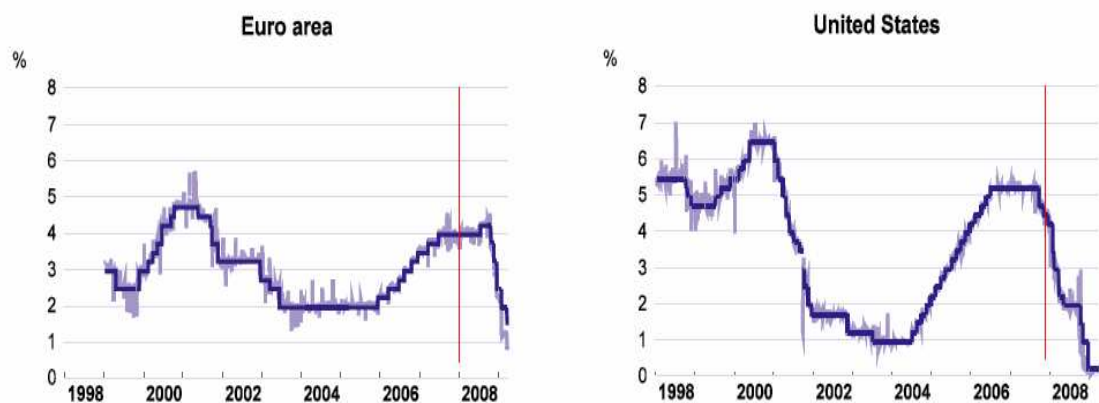
In arguing this, central bankers from this side of the Atlantic conveniently overlook the fact that, not so long ago, they allowed financial market turmoil to do the opposite. Interest rates on the three month money market were pushed up 50 to 75 base points over repo interest rates as early from September 2007 on and this until autumn 2008. Taking into the fact that monetary policy operates with time lags of one to two years, high money market rates from summer 2007 on imply that the ECB's monetary policy stance over the

¹ OECD Economic Outlook, Interim Report, March 2009.

past one year and a half has been one of the factors contributing to deepening the present recession.

The following graphs illustrate the enormity of the blunder made by the ECB: It took nothing less than nine months after economic activity went into recession (indicated by the red line on the graph) before monetary policy finally started to operate repo rate cuts. And as if this wasn't enough already, the ECB even hiked repo rates in July 2008 at a moment the economy was already in recession.

The Federal Reserve Bank on the other hand acted immediately. From the moment the economy came down from its cyclical peak, the US interest rate was cut.



Notes: The dark blue line represents the main policy rate of the central banks. The light blue line plots the effective overnight rate.

The red vertical line represents the time of entry into recession according to the CEPR for the Euro area and the NBER for the US.

Source: E. Laurent (OFCE) using OECD 2009 Graph (p. 39)

V. Overestimating the policy response: The zero bound on nominal interest rates

The argument that interest rates in the euro area are at present close to US interest rates testifies to an even higher degree of complacency. With US policy interest rates hitting the nominal zero bound, the Federal Reserve is unable to drive interest rates further down. Given the awful state of the US economy, Fed chairman Breanne and co would certainly want to get short-term interest rates even lower but they simply can't.

This biases the comparison in favour of the ECB. Indeed, if one waits long enough, European Central Bank interest rate policy automatically starts to resemble Federal Reserve policy: In a marathon even the slowest runner eventually catches up with the rest of the team when the finish is in sight.

Moreover, the fact that euro area interest rates are approaching US rates should not comfort but alarm European Central Bankers: It implies the European Central Bank is losing the battle against rapidly falling inflation pushing up real interest rates in the midst of a recession. This is a recipe for disaster: If inflation gets low enough and tips over into deflation, real interest rates will rise even more and recession and deflation will become self feeding. Instead of hiding behind biased comparisons with Federal Reserve policy, European Central Bankers should be extremely concerned and worried about this scenario of deflation unfolding itself.

VI. Overestimating the policy response: Real quantitative easing of monetary policy is also overdue

With interest rate policy being constrained by the zero bound, the Federal Reserve and the Bank of England recently switched to a policy of monetary quantitative easing buying private paper and government bonds. In doing so, they are trying to bring market interest rates down at the longer end of the market and not only at the shorter end.

European Central Bankers reply to their peers' non - conventional monetary policy by referring to the ECB's policy of 'enhanced credit provision': By injecting massive liquidity into the banking sector, the ECB's balance sheet has exploded up to 16% of GDP. This is actually higher than the Fed's balance sheet which is at 13% of GDP².

In doing so, European central bankers once again confuse a sign of financial market distress with a sign of adequate policy response. The major expansion of the ECB's balance sheet is, once again, pointing to the fact that things are alarmingly wrong: With banks still distrusting each other and unwilling to lend to each other on the interbank market, the ECB has become a clearing house. Banks which do possess excess liquidity hoard this money and park it with the ECB, while banks in need of liquidity turn to the ECB's lending facilities. Logically, this boosts the central bank's balance sheet, as well as central banking profits³. However, it is difficult to see why this should be read as a signal that monetary policy is doing enough. While a total meltdown of the banking sector is certainly prevented by this enormous liquidity injected by the European Central Bank into the banking system, this liquidity does not flow into the economy to support credit expansion and investment. The liquidity provided to one part of the banking system simply returns back to the ECB's balance sheet in the form of deposits from the other part of the banking sector. The economy is in a 'liquidity trap' and European Central Bankers present this as 'quantitative easing of monetary policy' and as an aggressive policy response to the crisis! Once again, alarming signs pointing to economic collapse and failure of policy to bring the economy back into shape are being used to justify an attitude of policy complacency.

VII. Conclusion: Economic Policymakers in Europe are hiding their heads in the sand

There is but one conclusion to draw and this conclusion is extremely worrying. Both finance ministers as well as central bankers in Europe are systematically misreading the signals coming out of the economy: Historically high public deficits and low nominal interest rates are not to be seen as a sign that fiscal and monetary policy is providing an appropriate response to the crisis. It is the opposite that is the case. High deficits and near zero interest rates are telling us that policy is actually losing the battle against depression and disinflation and that more and better and not less policy actions are to be undertaken. If policymakers in Europe do not get their reading of the economic signals right, then worse for our economies is still to come.

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² These figures also ignore that the increase of the central bank's balance sheet since end 2008 is much larger in the US than in the euro area. Also, recent decisions of the Federal Reserve are estimated to boost the Fed's balance sheet up to 33% of GDP...

³ Until recently, the ECB was lending money at rates which were 100 to 200 base points higher than the interest rate the ECB pays on deposits. This interest rate margin, applied to huge volumes of lending and borrowing, has delivered enormous profits to the ECB.