Europe 2013 – Recovery Or Relapse
Unfinished Business For Overindebted Economies?

Frank Veneroso

“The Eurozone Crisis, Greece, and the Experience of Austerity”

Athens, Greece

November 8-9, 2013

Megaron Athens International Conference Centre
A conference organized by the Levy Economics Institute of Bard College
with support from the Ford Foundation
Abstract

The following reviews the European crisis and the latest European economic data. It then asks about the immediate future. Basically the crisis was about the fatal flaw in the euro identified by Peter Garber a long time ago – a proneness to bank deposit runs. In early 2012 fiscal austerity led to economic weakness and a focus on sovereign debt. That in turn led to a bank run on the periphery - the fatal flaw of the euro. Then came Super Mario who, with a wave of his magic wand in August, somehow ended the market panic without ever having to use his OMT. It was a triumph of expectations management. In the winter that followed there was a serious recession as the financial crisis worked its way with a lag into aggregate demand and output. But by then all the financial conditions had improved, thanks to Super Mario, and that improvement led to the rather amazing green shoots of this past spring. Now, in the latest months, the data on Europe has become mixed; there is a loss of momentum and a possibility of relapse. The odds may well favor “muddle through” – the consensus expectation. But the coast is not clear.

So what will drive Europe now. These last two years were about bank runs and market panics over sovereign debts and euro exit. Private debt was in the background. But European private debt is extremely high and its ratio to GDP has not gone down over these last years. So there is still a private debt threat. This is Minskian. And inflation is falling, so there is a deflation threat, which is Fisherian. We cannot know if there is another shoe to drop, but if there is it will have to be Minskian and triggered by the disappearance of debt alleviating inflation. And heaven help Europe if the economies on the periphery adjust to the prevailing current account imbalances by deflating their price levels. Because then there could be deflation in Europe, and, with still sky high private debt, it might suffer a Fisherian debt deflation outcome. And remember, there is still no system wide deposit insurance; the fatal flaw in the euro has never been addressed, and it would probably resurface in such a Fisherian outcome.
Crisis Europe: A Saga In Six Parts

• Part I - Bank Runs 2012, The Fatal Flaw In The Euro
• Part II - Super Mario Calms Panicked Financial Markets
• Part III - The Legacy: A Dark Winter Of Recession
• Part IV - Spring 2013: Suddenly Green Shoots Everywhere
• Part V - Late Summer 2013; Relapse?
• Part VI - Looking Forward, Through A Glass Darkly
PART I: THE ARMAGEDDON SCARE
The Fatal Flaw Of The Euro

“In one of the earliest papers on European monetary union, Ingram (1973) notes that in such a union “payments imbalances among member nations can be financed in the short run through the financial markets, without need for interventions by a monetary authority. Intercommunity payments become analogous to interregional payments within a single country”.” This view was not challenged in the debate of the 1980s and the 1990s on the economics of Economic and Monetary Union (EMU). It quickly became conventional wisdom. The European Commission’s One Market, One Money report (1990) similarly posits that “a major effect of EMU is that balance-of-payments constraints will disappear [...]. Private markets will finance all viable borrowers, and savings and investment balances will no longer be constraints at the national level”.”

“The benign view prevailed during the first ten years of EMU. It even continues to dominate today.”

“For Twenty Years, False Confidence”

“Sudden Stops In The Euro Area”, Silvia Merler and Jean Pisani-Ferry
Bruegel Policy Contribution
March 2012
"To our knowledge, the only one to challenge this benign view was Peter Garber in a 1998 paper on the role of TARGET in a crisis of monetary union (Garber, 1998). The paper insightfully recognized that the federal structure of the Euro system and the corresponding continued existence of national central banks with separate individual balance sheets made it possible to imagine a speculative attack within monetary union. According to Garber, the precondition for an attack “must be skepticism that a strong currency national central bank will provide through TARGET unlimited credit in euros to the weak national central banks”. His conclusion is that “as long as some doubt remains about the permanence of Stage III exchange rates, the existence of the currently proposed structure of the ECB and TARGET does not create additional security against the possibility of an attack. Quite the contrary, it creates a perfect mechanism to make an explosive attack on the system”.

“Sudden Stops In The Euro Area”, Silvia Merler and Jean Pisani-Ferry, Bruegel Policy Contribution, March 2012

Fatal Flaw Exposed In 2012
Target 2 Balances, Q2 - 2012

The Bank Run: From The Weak To The Strong
Deposit Run Potential - Staggering

Spain’s De Guindos Says Euro's Fate at Stake in Next Weeks, Bloomberg, June 4, 2012

De Guindos said the balance of payments data, which showed an outflow of 97 billion euros in the first quarter, didn't reflect "capital flight," and underlined how Spanish banks were struggling to roll over funding on money markets. The outflow from individuals was about 1 billion euros in the first quarter, he said.

"What this shows is not capital flight, but the financing difficulties of Spanish banks in money markets," he said. "Spanish banks are having growing difficulties accessing money markets mainly in Europe: in the U.S. the money markets are very much closed to all European banks."

Spain's M3 was € 1138bn in March. At the same date, Spanish banks' total liabilities were € 4231bn, € 2277bn of which domestic. Total deposits were € 2991bn, almost 3 times M3.

Spain: Deposits = 3 X GDP AT Risk
Suddenly The European Economy Starts To Shudder
Alarm! Is It One Minute To Midnight In Europe?

“Joschka Fischer, Germany’s former vice-Chancellor: said EU leaders have two weeks left to save the project.”

Ambrose Evans-Pritchard, “The week that Europe stopped pretending”  
June 3, 2012

Prime Minister Mario Monti: “we have one week to save the euro zone.”

Source: The Guardian

“On a recent visit to Barcelona, one of us was repeatedly asked if it was safe to leave money in a Spanish bank. This kind of process is potentially explosive. What today is a leisurely “bank jog” could easily become a sprint for the exits. In the event of a Greek exit, rational people would ask: who is next?”

Niall Ferguson and Nouriel Roubini, “Is it one minute to midnight in Europe?”  
Financial Times, June 11, 2012
PART II: Super Mario

A Triumph Of Expectations Management
Alarm Leads To Market Panic

In Mid Summer 2012 Peripheral Rates Soar
In Mid Summer 2012 Peripheral Rates Soar
Spain, Summer 2012

The Deposit Run Intensifies
Super Mario To The Rescue

In August the ECB announced its program of outright monetary transactions (OMT) that would purchase European sovereign bonds in the secondary market. This would add to already existing ECB support to beleaguered European banking systems. The policy worked wonders. The “announcement effect” reversed the intense speculation in peripheral bond markets, as the charts just reviewed all showed.
In Summer 2012 The Euro Had Also Weakened

Bloomberg, November 3, 2013
Pounded Down By Unprecedented Speculative Short Selling

Which Super Mario’s Expectations Management Reversed
With A Little Help From Friends?

The Collapse In ECB Net External Assets Was Due To A Surge In Foreign Exchange Liabilities. Swaps From Official Friends Abroad?

Eric Barthalon, November 6, 2013
Existing ECB Support Operations Intensified In That Panic Period Until The Markets Dramatically Reversed.

In The End The OMT Was Not Needed
In principle, euro system wide deposit insurance should have been needed to staunch the bank runs in the periphery. In fact, it wasn’t. As the decline in Target 2 liabilities shows.

Expectations Management And ECB Liquidity Facilities Did The Job

Eric Barthalon, November 6, 2013
Super Mario. Hurrah!
PART III:
The Cold Dark Winter
Financial Panic Subsided But The European Recession Deepened
During The Winter European Bank Credit Contracted

Credit situation

Bank credit to firms
(annual rate of growth)

Notes: MFIs loans to non-financial corporations adjusted for loan sales and securitisation, 3-month moving average.
Latest observation January 2013. Source: ECB.
And So Did The Economy

Such Double Digit Declines Were Depression Type Numbers

Bloomberg, November 6, 2013
Spain Real Retail Sales

Such Double Digit Declines Were Depression Type Numbers

Bloomberg, November 3, 2013
Retail Sales Contracted All Across Europe

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<td>-8.2%</td>
<td>-5.8%</td>
<td>-6.1%</td>
<td>-6.3%</td>
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*Bloomberg, October 2013*
Even In Germany Real Retail Sales Fell

A Winter Contraction

*Bloomberg, October 2013*
Then Came The Cyprus Crisis. A Template For Renewed Bank Runs

“In the bailout of Cyprus, Germany went too far. In order to minimize the cost of the bailout it insisted on bailing in bank depositors. This was premature. If it had happened after a banking union had been established and the banks recapitalised, it might have been a healthy development. But it came at a time when the banking system was retreating into national silos and remained very vulnerable.”

“What happened in Cyprus undermined the business model of European banks, which relies heavily on deposits. Until now the authorities went out of their way to protect depositors. Cyprus has changed that. Attention is focused on the impact of the rescue on Cyprus but the impact on the banking system is far more important. Banks will have to pay risk premiums that will fall more heavily on weaker banks and the banks of weaker countries. The insidious link between the cost of sovereign debt and bank debt will be reinforced. The playing field will become even more uneven than

George Soros, April 9, 2013
The Stage Was Set For Another Bank Run On The European Periphery And Yet More Recession
PART IV: MIRACULOUS RESURGENCE?
Who would have thunk it? Portuguese house prices were falling, private non-financial debt still more than 200% of GDP, the work force was probably shrinking because of out-migration, and if any country should have had contagion from Cyprus in the form of deposit outflows, it was Portugal.
From Negative To Positive

Germany Real Retail Sales

From December Through April: Four Months With 3-month Smoothed Gains At A 3.6% Annual Rate
A Sudden Spring Surge

Netherlands Industrial Production

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<tr>
<td>YOY%</td>
<td>0.2%</td>
<td>8.1%</td>
<td>-3.3%</td>
<td>3.0%</td>
<td>2.1%</td>
<td>0.5%</td>
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European Commission, Brussels
June 12, 2013
Powerful Sudden Improvement

Bloomberg, June 2013
Sentiment On The Mend
Why The Miraculous Recovery?

Several Improvements In Financial Conditions
Why The Miraculous Recovery?
Austerity Fatigue.

The Spanish authorities have apparently lied about their fiscal situation for years now: they reported significantly lower fiscal deficits and then they revised the data up to show virtually no such reduction. Therefore, we cannot trust the Spanish fiscal reports. It may be that things have now become so bad in Spain and the social and political opposition to austerity has become so strong that the Spanish have effectively jettisoned all fiscal austerity and there is some measure of incipient stimulus.
Why The Miraculous Recovery?
The Revenge Of Say’s Law

The history of economic contractions for all economies tells us that, after very severe economic contractions, there can be a “V” shaped economic recovery, and when that happens the data reverses suddenly, surprisingly, and almost miraculously.

Extremely deep contractions never continue indefinitely: despite the highest private debt in the U.S. ever, sky-high double digit real interest rates thanks to severe price deflation, a deepening banking crisis, and no upturn in the money supply, U.S. industrial production bounced explosively in the third quarter of 1932. There was a double bottom in March 1933 followed by a 61% rise in the next twelve months. From the second quarter of 1933 to the beginning of 1937 overall GDP grew faster than at any other time in U.S. economic history.
PART V:
Q3 2013 From Resurgence To Relapse?
On a three-month smoothed basis there was an improvement in late winter and early spring. Since then the data has lost considerable forward momentum. There is a 3% annualized rate of decline in this data over the last four months, a .4% annualized rate of decline over the last three months, and a 3.6% annualized rate of decline over the last two months.
Germany, Strong Man Faltering?

Germany: Industrial Production Year On Year

Bloomberg, October 30, 2013

Choppy?
Germany
Strong Man Faltering?

Germany Factory Orders

Zero improvement in German factory orders from March to August after the prior months showed a big surge. But the September data says the recovery may be still intact.
Germany
Strong Man Faltering?

Over the last two months total employed has barely advanced. This feeble short-term trend is worse than the experience of 2012 when total German employment growth remained decently positive, even though many other economic indicators turned quite negative.
French industrial production has fallen for the third month in a row, giving back much of the earlier year improvement. The very recent trend looks quite negative.
Real consumer spending over the last two months has been quite negative. The year on year percentage change averages zero over the last two months, down from positive numbers in the spring when Europe overall surged. So the year on year very smoothed data also says the sequential trend has turned negative.
France
Another European Economy That Is Now Faltering

As for employment, the data on job seekers showed sudden summer improvement. But that was statistical error. This measure now shows a negative employment trend persists, but at a lesser rate of decline.

Zero Hedge, October 24, 2013
Italy
Still In Trouble

Retail sales continue to be in decline

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<td>-0.3%</td>
<td>-0.2%</td>
<td>0.1%</td>
<td>0.0%</td>
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<td>-0.1%</td>
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**Index level (2005=100)**

|               | 95.3 | 95.6 | 95.8 | 95.7 | 95.7 | 96.0 |

*Source: Istituto Nazionale di Statistica (ISTAT)*

September 26, 2013
Italy
Still In Trouble

Italy Industrial Production

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<tr>
<td>Total</td>
<td>-0.3%</td>
<td>-1.0%</td>
<td>0.2%</td>
<td>0.1%</td>
<td>-0.3%</td>
<td>-0.8%</td>
<td>-0.9%</td>
<td>1.0%</td>
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<tr>
<td>3-mo change (*)</td>
<td>-0.5%</td>
<td>-0.5%</td>
<td>-1.0%</td>
<td>-1.2%</td>
<td>-0.9%</td>
<td>-0.3%</td>
<td>-0.9%</td>
<td>-1.8%</td>
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<tr>
<td>Workday adjusted</td>
<td>-4.6%</td>
<td>-4.2%</td>
<td>-2.1%</td>
<td>-4.3%</td>
<td>-4.7%</td>
<td>-5.3%</td>
<td>-4.0%</td>
<td>-3.3%</td>
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Instituto Nazionale de Statistica (STAT), Rome
October 10, 2013

Here is the official industrial production data. It continues to decline. The rate of decline is less than it was at the end of last year. But both the month on month and year on year data would suggest that, even in the most recent months, industrial production has been declining at somewhere between a 2% to 5% annual rate. That is a steep rate of decline.
Italy
Still In Trouble

September data shows a return to very negative employment, and that has dashed the more positive impression of recent months.
Netherlands
Getting Worse

Dutch Industrial Production

Production. Terrible. Down at a 12% annual rate over the last five months. Down at almost a 10% annual rate over the last three months. This is confirmed by the shift in the year on year change from positive to negative.
Netherlands
Getting Worse

Dutch Consumer Spending

Dutch Statistics Office, October 23, 2013

Consumer spending. If anything, it is getting worse.
Spain
Unlike The Rest Of Europe, Still Recovering

Retail sales keep improving year on year. That means they are surging sequentially.

Bloomberg, November 3, 2013
Spain
Unlike The Rest Of Europe, Still Recovering

Spain Employment

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<td>Net monthly change</td>
<td>71,245</td>
<td>5,636</td>
<td>-14,563</td>
<td>-57,505</td>
<td>-7,324</td>
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<tr>
<td>Net annual change</td>
<td>-375,573</td>
<td>-502,780</td>
<td>-565,735</td>
<td>-600,926</td>
<td>-631,190</td>
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<td>MoM%</td>
<td>0.44%</td>
<td>0.03%</td>
<td>-0.09%</td>
<td>-0.35%</td>
<td>-0.04%</td>
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Spanish Ministry of Labor, Madrid
November 5, 2013

October’s employment data is even more striking with a huge positive gain.
Spain
Unlike The Rest Of Europe, Still Recovering

Spain Industrial Production Year On Year
Work Day Adjusted

Industrial production miraculously reversed this past spring. To go from 10% negative year on year to 7% positive year on year is nothing short of miraculous. Too miraculous. Surely even such year on year smoothed data is highly distorted. But the more recent smoothed work day adjusted 2%-3% year on year declines after such deep 5% declines from mid-2012 through last winter suggest stabilization sequentially.
PART VI:
Is It Hy’s Time Now?
Unfinished Business For
Overindebted Economies?
Euro Country vs. Other Country Debt

Remarkably High European Non Financial Private Debt

McKinsey & Co. August 2013
## Too Much European Private Debt

### Eurozone Non Financial Company Debt

<table>
<thead>
<tr>
<th>Country</th>
<th>2Q 1Q 4Q 3Q 2Q 1Q 4Q 3Q 2Q 1Q 4Q 3Q 2Q</th>
<th>% of GDP</th>
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<tr>
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<tr>
<td>Portugal</td>
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<tr>
<td>Spain</td>
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<td>Germany</td>
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*European Central Bank, Frankfurt*

*October 30, 2013*
Too Much European Private Debt

There Is Almost No Real Household Deleveraging Yet

Eurozone Non Financial Company Debt

<table>
<thead>
<tr>
<th></th>
<th>2Q</th>
<th>1Q</th>
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<tr>
<td>Eurozone</td>
<td>63.4%</td>
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<tr>
<td>Netherlands</td>
<td>127.4%</td>
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<td>127.7%</td>
<td>127.9%</td>
<td>127.5%</td>
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<td>Portugal</td>
<td>89.8%</td>
<td>91.0%</td>
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<tr>
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<td>81.6%</td>
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<td>83.6%</td>
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<td>45.4%</td>
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*European Central Bank, Frankfurt*

*October 30, 2013*
Debt Alleviating Inflation Is Falling

Eurozone Inflation YoY

Bloomberg, November 3, 2013
Inflation Expectations Are Falling

Bloomberg, November 6, 2013
The ECB – EU Policy Of Peripheral Adjustment Threatens Deflation

• Last November 1 gave us a glimpse of the biggest danger facing the eurozone in the next decade: a period of sustained deflation. Eurozone core inflation – without energy prices and other volatile items – tumbled in October to an estimated annual rate of 0.8 per cent.

• I doubt even a marginally negative interest rate would avert a slide into deflation. Its deep cause lies in the way the eurozone responds to its debt crisis – through austerity and falling real wages in the periphery and a lack of adjustment in the north.


With High Private Debt An Outright Price Deflation Would Reignite Crisis
Money Growth Foreshadowed The 2012 Recession And The 2013 Recovery

Is The Recent Fall In Money Growth Ominous?

Bloomberg, November 3, 2013
Money Growth Foreshadowed The 2012 Recession And The 2013 Recovery

Is The Recent Fall In Money Growth Ominous?

Bloomberg, November 3, 2013
Despite Successful Super Mario Expectations Management, Private Credit Flows Have Gone Negative Again

Figure 8
Eurozone loans to the private sector

Source: ECB

Christopher Wood, CLSA, October 31, 2013
This Is Mostly The Unwind Of Target 2

But Is The ECB Doing what Japan Did 20 Years Ago And Not what Bernanke And Kuroda Are Doing Today?
Is EU Policy Making Matters Worse?

- The findings by Fitch Ratings are set to raise alarm bells among European policy makers seeking ways to push banks to expand corporate lending to boost the continent's slow economic recovery.

- The rating agency's research, to be made public on Monday, shows that Europe’s 16 largest banks have increased their risk exposure to sovereign debt by 26 per cent or €550bn in 2011 and 2012.

- At the same time, banks have reduced their risk exposure to corporate credit by 9 per cent or €440bn, according to the research, which looked at those lenders labeled as “systemically important” by global regulators last year.

European Banks Cut Corporate Lending, Financial Times, November 2, 2013

Corporate Credit Is Contracting
Is Basel III Making Matters Worse?

• Fitch’s analysts said incoming global Basel III capital rules were at least partly to blame. “Basel III already appears to be influencing banks’ capital management, exposure allocation and credit strategies,” said Martin Hansen, macro credit analyst at Fitch.

• The rule-book, which is being phased in until the end of 2018, severely tightens minimum capital requirements, “turbocharging” existing incentives for banks to invest in sovereign bonds while making corporate lending still costlier.

European Banks Cut Corporate Lending,
Financial Times, November 2, 2013
Or Is There Simply Too Much Debt And Bad Demographics?

- Bankers stressed that a lack of economic growth in Europe is pushing lenders into sovereign bonds as there is little demand for loans from companies.

- “There is nothing else to invest in with our excess cash,” said Andreas Treichl, chief executive of Erste Group, one of Austria’s largest banks. “That is the real problem of Europe, there just isn’t another choice. I’d love to lend more to companies instead but there is just not enough growth.”

*European Banks Cut Corporate Lending, Financial Times, November 2, 2013*
And Remember

• Expectations management and liquidity provision calmed the markets in 2012

• There is still no system wide deposit insurance

• Therefore the fatal flaw in the euro remains

• And it probably cannot withstand a price deflation
One Last Consideration

• Why is private debt in Europe so high?
• Did the welfare state foster a pervasive moral hazard that distorted downward the perceived risk of loss of lenders and borrowers? And thereby encourage excess debt.
• Is this what Hyman Minsky would say?
• Is euro area “adjustment” chipping away at the supports of the welfare state so that lenders and borrowers no longer find their private indebtedness tenable?
• Is this an unrecognized insidious force for price deflation that overindebted Europe cannot withstand?