Hyman P. Minsky Conference on Financial Instability

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ECB Worries/European Woes: The Economic Consequences of Parochial Policy

[Alter schützt vor Torheit nicht*]

Executive Summary

Financial market crises, threatening debt-deflation depressions, occurred with increasing regularity in the U.S., from 1980 through the present. Almost reflexively, when confronted with such circumstances, U.S. institutions and the policy makers that ran them responded in a fashion that consistently thwarted debt-deflation-depression dynamics. It is true that these 'remedies', as they succeeded, increasingly contributed to a moral hazard in U.S. and global financial markets that culminated with the crisis that began in 2007. Nonetheless, the straightforward steps taken by established institutions enabled the U.S. to derail depression dynamics, while European 1930s style austerity proved as ineffective as it was almost a century ago. European and specifically German steadfast refusal to embrace the U.S. recipe has fostered mushrooming economic hardship on the continent. The situation is gruesome, and a serious student of economic history had to know, given European policy commitments, that it was destined to turn out this way.

It is easy to understand why misguided policies drove initial European responses. Economic theory has frowned on Keynes. Economic successes, especially in Germany, offered up the wrong lessons. And enduring angst about inflation was a major distraction. At the outset, the wrong medicine for the wrong disease was to be expected.

What is much harder to fathom is why such a poisonous elixir continues to be proffered amid widespread evidence that the patient is dying. Deconstructing cognitive dissonance in other spheres provides an explanation. Not surprisingly, knowing what I want to happen at home completely informs my claims concerning what will be good for my neighbors.

In such a construct, the last best hope for Europe is Mario Draghi. He seems to be able to speak German and yet act European.

*Age does not protect from foolishness

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U.S. Post-War Stabilization Policies

I. Minsky's Insights about America's Post-Depression Strategy

Unquestionably, the 2007-2009 financial shock delivered to the world was of depression-like proportions. Precisely because the devastation was so powerful, appreciation of how to thwart depression dynamics should have been the centerpiece of European economic discussions. How did the U.S. combat such powerful destabilizing influences? Hy Minsky provides the best summary of what kept 'It" from repeating in the U.S.A. Minsky liked to say that depression was avoided when financial crises erupted, a consequence of two things, a big government and a big bank. He pointed out that the legacy of the Great Depression in the U.S. was that, independent of political party in power, essential things were delivered by the 'big government' and the big bank':

Big government stands behind economy wide deposit insurance.
Big government 'knows instinctively' that it must recapitalize commercial banks.
Big government supports demand via automatic stabilizers.
Big government supplements demand support via fiscal stimulus.

To complement 'big government' efforts,

Big bank's massive liquidity infusion, restores market flows.
Big bank's liquidity infusion renders Big government borrowing an easy proposition.
Big bank's aggressive ease counters market risk aversion. They collapse the risk free rate, force money out the risk curve and restart the economies' credit engine.

In short, having a national entity that stood ready to guarantee bank deposits and replenish bank capital was essential to derail the bank deflation dynamic. Likewise, via automatic stabilizers and proactive legislation, fiscal policy was brought to bear to support demand. The central bank, created with Bagehot's insights in mind, knew that its essential role was as lender of last resort. It stood ready to provide liquidity to private markets and to make public sector borrowing easy. In addition, it came to understand that aggressive commitment to ease was the necessary antidote to the violent shift toward risk aversion that is one of the hallmarks of serious financial crises.

What about inflation? In the late-1970's and early 1980's, amid a virulent inflationary dynamic, central banks practiced intermittent disinflation. They attended to inflation-fighting responsibilities but interrupted such efforts when they threatened the safety and soundness of the financial system. However, since the mid-1980s, inflationary pressures, despite central bank focus, have in fact been a sideshow. Center stage since l987 has been the interaction between financial system swings and the real economies boom and bust cycle. [1]

II. Ignore Minsky At Your Peril

The 2007-2009 financial system collapse in important ways actually exceeded the 1930s experience. Accordingly, enlisting Minsky's menu of stabilization strategies efforts has never been more important in the post war period. Roughly speaking, that is what occurred in the U.S. In Europe, instead, these time honored, if reviled, rescue traditions were ignored. And we confront today the devastating legacy of those decisions.

In the U.S.A., despite a great deal of free market rhetoric and teeth gnashing the multi-faceted safety net was employed. The USA now sports functioning banks, a nascent rebound in residential real estate in the bubble states and three years of slow but steady economic growth. That said, the U.S. just concluded an election

[1] The Cost of Capitalism, R.J. Barbera, 2009

wherein the losing candidate had as a platform position, a desire to replace its central bank chairman, largely on the grounds that he did too much to try and make things better. And at the moment, there is some risk that, by default, the U.S. will slide into recession a consequence of automatic draconian austerity. But although the U.S. is threatening to be stupid, so far, at least, it has done okay.

In stark contrast, the 17 Nations saddled with the euro and its steward, the ECB, remain trapped in a system of still dysfunctional banks, deteriorating Depression like conditions for bubble states and, in aggregate, a return to recession. This tragedy, in part, reflects the fact that the institutions in place among the euro nations are not set up to easily respond as Minsky insisted they should. The absence of these vital institutions is not entirely an accident of course, as many of the architects of Europe argued, and continue to insist that such institutions and policies are not necessary.

In sum, a consequence of institutional inadequacies and insanely wrongheaded policy maker biases, Euro nations, in toto, have slid closer to a repeat of the Great Depression than any Developed economy since the 1930s.

This paper asks the question, WHY? More specifically, amid three years of failure, with a robust literature speaking to the error of their strategies, why did the core nations insist on doubling and then tripling down on their failed plan. As jobless rates soared, riots proliferated, financial market fissures multiplied, what possible motivation caused policy makers, then AND NOW, to insist that ever more austerity, redoubled central bank indifference to anything but prices, and impossible to achieve host nation responsibility for banks was the right way to go? Why, indeed?

Financial Crisis Revisited

In late 2009, imagine the following. Obama advisor Larry Summers and Fed Chairman Bernanke meet with Bundesbank head Axel Weber and ECB head Jean Claude Trichet. The Americans explain their plan.

> *We're bailing out our banks, applying serious stimulus and postponing any focus on out-year fiscal tightening. We're collapsing rates to zero, and we're going to explode the Fed's balance sheet to drive all interest rates lower, lift risky asset prices, and hopefully restart the economic engine.*

Trichet and Weber, with horrified looks on their faces, implore the Americans to reconsider.

> *Banks must be held accountable or restructured in the areas in which they reside. Fiscal austerity applied in earnest will be stimulative as it brings confidence to all businesses. So too will vigilant monetary policy, policy aimed exclusively at keeping inflation at bay. This is our plan.*

Summers guffaws,

> *No Euro wide bank bailout will translate into continued credit contraction for the periphery. Austerity, in the short run, ALWAYS drives economies DOWN, not up. And easy money is the only way to ease pressures on public and private borrowers, and thereby end the adverse feedback loop that the Great Recession has begun. Your policies will doom Europe to deep retrenchment and probable euro break-up.*

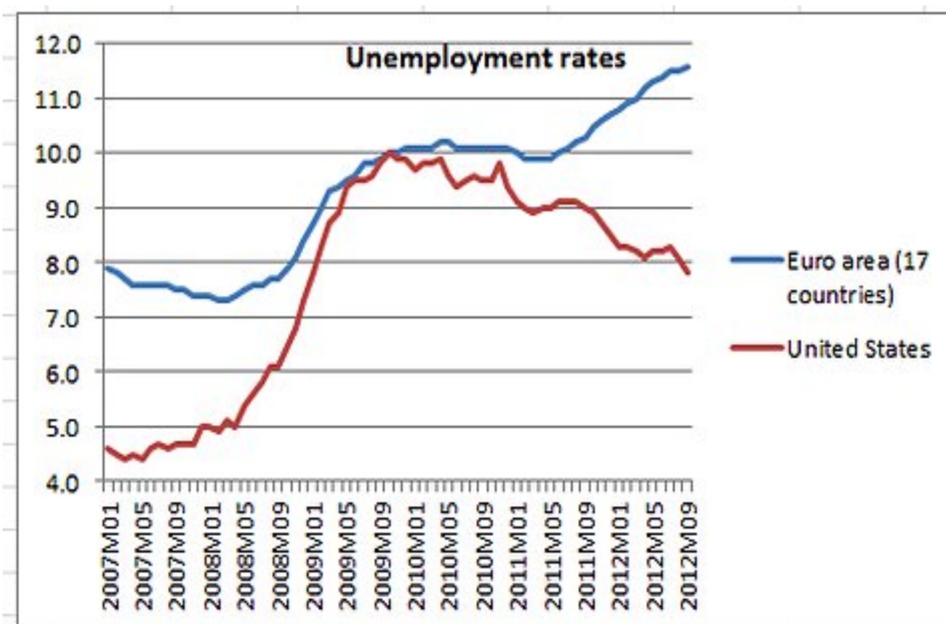
Trichet retorts,

> *Public monies for bank bailouts create great moral hazard. Swelling deficits will drive your bond yields sharply higher crowding out business investment. Printing money means a plunging currency and sharply higher inflation. These policies will ensure your economic malaise for the next decade.*

III. Facts on the Ground

How did things work out? On nearly all counts, European hopes were dashed. Likewise, their admonitions about risks to U.S. policies all proved to be wrong. In general U.S. economic barometers tilted into positive territory. There was much that was lacking in the U.S. effort. But from the fall of 2009 through the late fall of this year, the U.S. economy grew modestly, amid tame inflation and blessed by a slow but discernible fall for unemployment — down roughly two percentage points over the period.

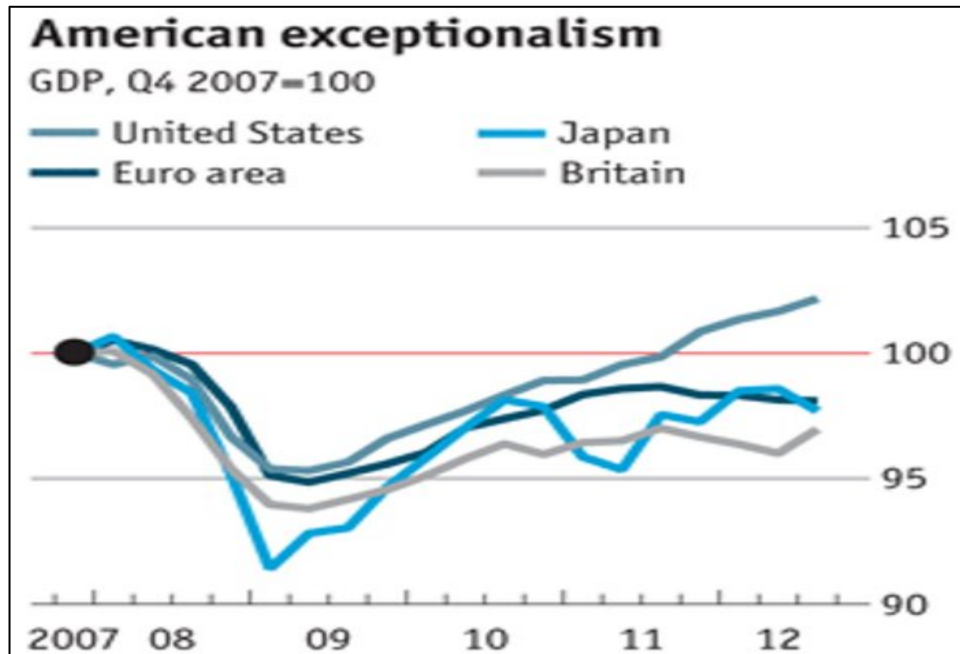
In Europe, the resulting devastation for the real economy has been breathtaking. From the fall of 2009 through late this year, European economies, one by one, either watched nascent rebounds expire or watched recessions dramatically worsen. Aggregate statistics tell the tale, though they disguise the depth of the disaster. European unemployment is in the midst of a second climb, as the continental economy has double dipped. Thus measures of joblessness in the U.S. and Europe were passing ships in the night. As the U.S. rate fell back from 10% to a bit less than 8%, the European rate soared, climbing from 10% to nearly 12% at last count. Real GDP growth tells the same story. Both Europe and the U.S. emerge from recession with tepid recoveries, output gains averaging around 2%. Over the four quarters through Q3:2012, however, U.S. economic growth improved ever so slightly. In painful contrast, policy ineptitude in Europe delivered a double dip, as output contracted by 0.6% over the period. Again, however, the aggregate statistics mask insane devastation in a number of countries. Greece, all agree played a central role in its own demise. But the horrific state of affairs with unemployment now at 10.7% in Italy, 14.8% in Ireland, and a breathtaking 25.5% in Spain is profoundly sad. To put Spain's plight in some simple mathematical context, at the end of September of 2007, Spain's jobless rate stood at 8.4%. Generalized strikes, regional threats of cessation, emasculated political leadership, all come with the territory when economies collapse. And Spain's economy has done precisely that.



Source: Paul Krugman, Blog

III. Recent Results

The chart below, taken from the Economist blog in combination with a Paul Krugman chart on joblessness (page 5) make it clear that American policy won the debate imagined on page 4.



Source: The Economist

Indeed, America's strategy delivered some upside and all but completely avoided the downside consequences that Europeans asserted were inescapable amid super easy policies. A debauched currency, and climbing inflation and long term interest rates were alleged to be near at hand, after each of three QEs. And yet, as the table below makes clear, U.S. inflation has done NOTHING. Indeed, whether one looks at 10-year inflation, 3-year inflation, 1-year inflation or inflation over the past six months, if anything is in the data, it evidence of FADING inflationary pressures. Likewise, U.S. long term interest rates have trended lower and the dollar over the past several years, is a bit higher versus the hard money, austerity crowd of Europe.

U.S.A. Annualized Inflation Rates				
	6-Month	**1-Year**	**3-Year**	**10-Year**
PCE	1.5	1.7	2.1	2.3
PCE Core	1.4	1.7	1.6	1.9
Wages	0.8	1.1	1.8	2.7
10-Year Note	1.6	2.0	3.2	4.2
$/Euro	1.28	1.37	1.49	1.0

And how do these results compare to Europe's inflation performance? There is little difference at all:

European Annualized Inflation Rate					
	6-Month	1-Year	3-Year	10-Year	
Consumer Price Index	1.3	2.6	2.8	2.4	

The only bouts with pressure emanated from commodity prices, captive to China.
It is also important to recognize that **both** inflation and **deflation** were absent, in any meaningful sense. Persistent large output gaps [PLOGS] face asymptotic wage and price curves as we get closer to de minimus price pressures. The ZERO Bound, it turns out, is an interesting concept for both monetary policy and for pressures on prices and wages — wages and prices are particularly sticky when outright declines loom.[2]

This leads, inescapably, to the second conclusion. If DEFLATION is very hard to generate then a central bank focused solely on inflation will deliver sub-optimal policy. If you solely look at prices, you will suffer substantial output and employment losses, relative to a central bank focusing on prices and jobs. In practice there is no *divine coincidence* that delivers comparable results for one and two target central banks.

Europe's Other Lamentable Outcomes

IV. Penalty Borrowing Rates, Bank Balkanization amid Silent Runs

The fact that austerity makes economies contract, and that central banks focused singularly on inflation versus dual mandates, produce sub-optimal outcomes, is the oft-heard lament of traditional Keynesians. But the depression thwarting institutions and policy responses that characterize post War U.S. history and are catalogued by Minsky also address more elemental issues that link banking/fiscal and monetary policy. Deposit insurance and central bank backstopping of sovereign debt are central parts of the post-war arsenal against a depression sequel.

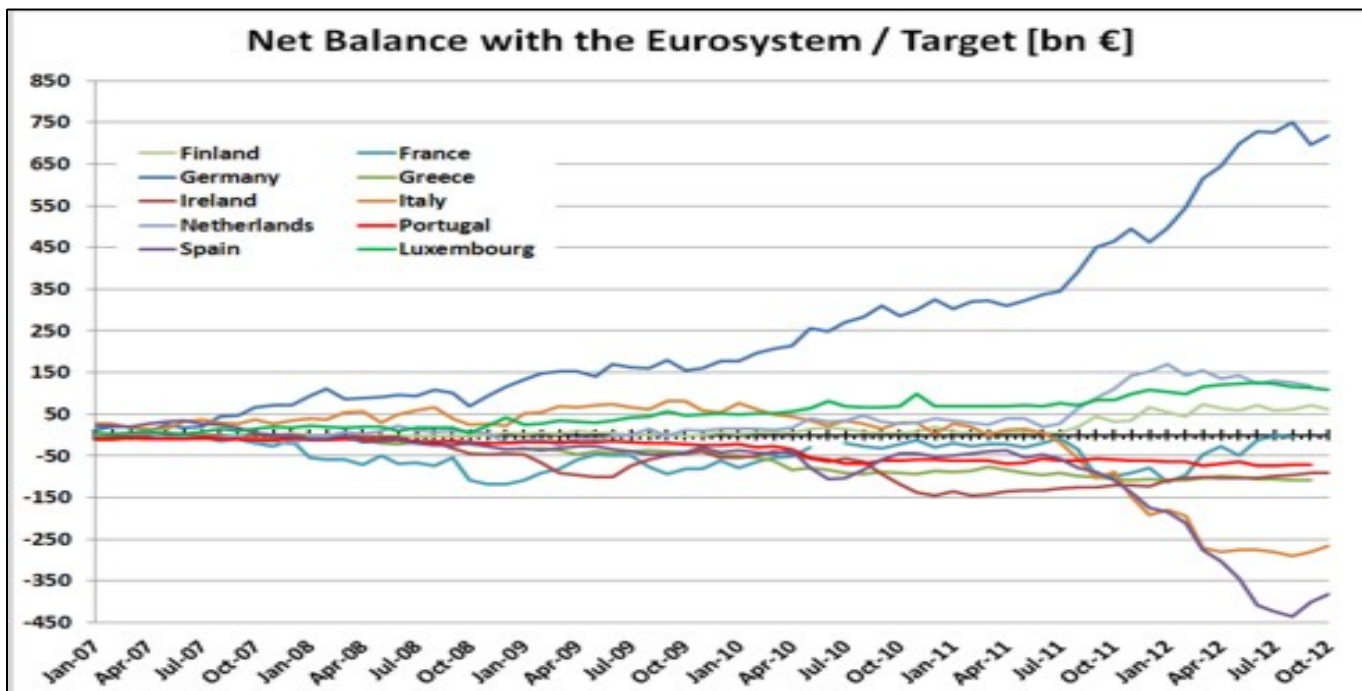
Does anyone really need a tutorial on what happens if depositors lose faith in their banks' deposit insurance? Apparently so in Europe. Despite one currency, European nations have 17 deposit insurance schemes. Core country acknowledgement that 'Greece may need to leave the euro', a year or so ago, put official imprimatur onto widespread financial market anxieties about euro nation expulsions/defections or collapse. Once we admit that Spain, for instance, might possibly leave the euro, why would an intelligent multi-national CFO chose to park funds in a Spanish bank, and run the risk of going to bed with 10 million euro and waking up with 10 million pesetas? Indeed if the risk is that the Spanish fishing village Mugardos was a leading indicator and pesetas will return, why would any rational individual keep their deposits in a Spanish bank? A quick trip to Germany, a shift of funds to Deutsch Bank and your funds are in a bank that has 250 branches and more than 23,000 ATM machines in Spain, and the bonus of a possible wild upward revaluation in local currency value, if Spain exits.

Precisely that kind of logic elicited gigantic money flows, late 2011 through first half 2012. Why no overt evidence of bank runs, and declarations of bank insolvencies? Euro area nations use the 'target II' system to reconcile bank flows. Over that period net outflows of Spanish and Italian banks exceeded 700 billion euros

[2] This should have shocked no one. See '*Still minding the Gap—Inflation Dynamics during Episodes of Persistent Large Output Gaps '*, Andre Meier, IMF Working Paper, August 2010.

and net inflows into German banks were of comparable magnitude. The bank run occurred. It was not prevented by euro area deposit insurance. It was accommodated by central bank flows.

Target II flows amount to the Bundesbank replacing the local depositors in Spain and Italy. This creates the following perverse situation. Germany is one of the staunchest naysayers, when it comes to instituting European deposit insurance. But Germany, via the ECB is already on the hook for supporting European banks that are subject to runs on deposits. If the euro broke up, unless Spanish and Italian depositors repatriated all their euro denominated cash, collecting gains in local currency that conversion would deliver, the loans would have to continue. The Bundesbank would be left with its share of the ECB's euro loans to Spain and Italy that surely could not be rapidly repaid, so long as the creditors insisted on hard currency.



Source: Euro Crisis Monitor – Institute of Economic Research – Osnabrüeck University

V. Default Risk vs. Inflation Risk And Self-Fulfilling Sovereign Debt Crises.

Why does Italy pay 4.9% for 10-year money and the U.K. 1.8%? We all know both nations have difficult fiscal situations that will be hard to balance. The U.K.'s deficit is much larger than Italy's. Italy has a much larger outstanding stock of debt. Difficulties of roughly comparable proportions. Nonetheless, the British borrowing rate is miniscule compared to that of Italy's. The reason for this powerful spread, of course, is that a lender to the U.K. risks being paid in inflated pounds, but she knows she'll get paid, thanks to the printing press at the Bank of England. In stark contrast, Italy has no printing press, and so, like a state borrower in the U.S., it could default on its loans. What is bizarre, of course, for Italy, is that its fiscal situation is not particularly threatening, if it has U.K. interest rates. Thus the absence of a central bank backstop produces the self-fulfilling prophesy of default risk in Italy.

These considerations seem quite straightforward. Yet they are vehemently denied by many in charge in Europe. And that makes them all the more important. As Keynes put it, "The difficulty lies not so much in developing new ideas as in escaping from old ones." (John Maynard Keynes, "The General Theory of Employment, Interest and Money" *Preface*.)

Unlearning History

VI. The Formative Years and Formulating the Wrong Diagnosis

How can so much policy be so terribly wrong? What people believe about economic policy is conditioned by three things:

- The economic text books they have read and what they were taught as students.
- Their own experience.
- Their vested interests – wishful thinking and an eye to personal advantage have a habit of affecting people's thinking if only subconsciously.

How have these things contributed to the current debacle? We know that Keynesian insights became unfashionable after the fast inflation of the 1970s and the growth of the new-classical school of macroeconomic analysis. Minsky had never been all that fashionable in the academies anyway. Considering his main publications date from the 1970s he was astonishingly prescient about the outlines of the 2007-8 crash, which gave him great credibility among financial market practitioners but in the academies and most policy circles he remains marginal.

The leading edge theorising of the late 1970s, when today's policy-makers were young and impressionable, was all about rational expectations, the Lucas critique of macro-models and Kydland and Prescott and their emphasis on credible precommitment – all downplaying the role of judgment and discretion in macroeconomic management and central banking. This is not the place for a detailed condemnation of 40 years of macroeconomic theorising. If the unreality of the assumptions underpinning much of that once-fashionable theory is not clear it is difficult to know what to say. And the known sensitivity of its conclusions to changes in those assumptions should put to bed all loose talk of "as if" theorising.

What should be common ground is that the real world is a much more turbulent place than the smoothly adjusting, full-employment world of the dynamic general equilibrium model. Events that happen every 10, 20 or even 70 years cannot really be "10 sigma" events. There's something wrong with the model. Even those who cling to such theorising most of the time must recognise that the system has pathologies the models do not encompass. From time to time the wheels come off and the system can crash in a spectacular way. Nor can we always blame it on the government. What exactly was the crime of the Spanish or Irish government in the run-up to 2008? Monetary policy? They had ceded that to the ECB, then being run on impeccable Bundesbank principles. Fiscal policy? They were running budget surpluses.

Any rational post mortem of the 2007-2009 crash must acknowledge that private speculation induced a spectacular instability in the way that Minsky foresaw and anatomised 40 years ago. In the crisis that such instability can generate the 'business as usual' policy maxims have to be abandoned. The first point is that many policy makers were as Keynes put it: "prisoners of defunct economists".

Secondly, the experience of many German policy-makers also led them astray. For a half century after the Second World War Germany managed its economy as if it were a small open economy. It was not too concerned about domestic demand, instead preferring to concentrate on keeping inflation expectations and wage settlements down relative to productivity growth, building international competitiveness and growing via trade. That was a very successful strategy and certainly better than the 'stop-go' policies of the UK as it tried to manipulate aggregate demand. Generations of German policy-makers became persuaded that their way was the virtuous way and their longstanding success was the reward for such virtue.

Finally, the formative experience of the youth of most policy-makers today was creeping inflation permitted by governments who accommodated it in the interests of maintaining full employment. When a drastic terms of trade deterioration after the first oil shock of 1973 turned creeping inflation into rampant inflation only a sharp dose of unemployment could re-stabilise that system. But that system gave way to a new one characterized by financial liberalisation and globalisation – and these factors changed the world. Before 1980 all post-world-war-two recessions were caused by periodic clampdowns by government on accelerating inflation. Hence, the emphasis on credible central banks, and inflation targets.

But since 1985 no substantial recession has been caused in that way. Every single one has been caused by financial instability – U.S. savings and loans in 1990 and Japan's spectacular bust, the Tequila crisis, the Russia sovereign debt crisis, the Asian contagion crisis in the late 1990s, the dot-com bust in 2000 and biggest of all the housing-based crash of 2007-8. We now have policy-makers confronting a large, semi-closed economy, the Eurozone, in the aftermath of the sort of collapse that unregulated, global financial markets will inevitably induce. And their economic doctrine and their experience lead them to treat it as the problem of a small open economy confronted by incipient inflation caused by fiscal indiscipline. No wonder we are in the mire.

It may be asked why the United States, the birth place of the inappropriate economic theories embraced in Europe, managed to escape their influence. The Great Depression of the 1930s has a much stronger influence on American thinking than it does in Europe. Many of the institutions of U.S. banking and economic management, like federal deposit insurance, were forged in that period. The Glass Steagall Act of 1932 was repealed only in 1999 and that is already regretted. In Europe the Depression led to a world war, fought largely on European soil. The trauma of war eclipsed the trauma of Depression in the popular memory and it also swept away pre-war regimes and institutions. There is less continuity than in America. The Federal Reserve Act was passed in 1913. The Bundesbank dates only from 1948. And Britney Spears has been in the news for as long as the ECB.

VII. From Bad to Worse amid Collective Cognitive Dissonance

All the above explain Core Nation's initial desires to see things from their own historical and theoretical perspective. But three years into this set of failed policies, how can we explain such persistent denial of fact? Sadly, we need to remind ourselves that denying the obvious, when the obvious hurts is a longstanding human trait. Indeed, in the U.S., two instances occurred quite recently. On election night many Republican strategists and enthusiasts were dumbfounded that Barack Obama was reelected. This was true despite the fact that a straightforward analysis of polling data in the last days leading up to the election gave Romney less than a 10% change of victory.[3]

A second example in the U.S. is perhaps more telling. Bloomberg News conducted a poll in the U.S. in September of this year on the question of global warming. They asked the following question, "Are humans warming the earth? The instructive part about the answers are found in the breakdown of the responses, sorted by political affiliation. As the table below reveals, belief in human contribution to rising temperatures was tightly linked to party affiliation, with 3 out of 4 democrats saying yes and only 1 out of 4 Republicans in agreement.

[3] Nate Silver, 538 Blog, on election eve, using standard statistical techniques, afforded Romney about the same chance to win as a poker player drawing to an inside straight.

Bloomberg News Poll Conducted in September 2012				
Humans warming the earth:				
		Democrats	**Independents**	**Republicans**
Percent Who Said 'yes'		78%	56%	26%

How can this be? The question being asked involves making judgments about the interplay between the sun as a heat engine, the earth's heat trapping atmosphere and the varied effects that the full panoply of human activity have on the atmosphere. How can political affiliation so powerfully influence opinions on such complex and profoundly apolitical questions? In most cases involving complex scientific questions, the public at large defers to the consensus of the scientific community. Is there a powerful spilt amongst scientists? In 2009, when 3,146 earth scientists were asked the same question 82% of them answered yes. The same study reports that of the scientists that focused primarily on the question of global warming, an overwhelming 97% agreed that human activity explains the warming of the planet.[4]

It is, sadly, obvious why politics dictates opinion on global warming. If you believe it is true, you must accept that it makes sense to investigate whether you should try and slow or end the process. And proposed efforts to reverse global warming all require large scale intrusion of the State. In effect, the logic works in reverse. I believe in free markets, not collective action, and therefore, I reject the notion that anything, including global warming, could be happening that justifies the intrusion of the State.

Perhaps we now have a method to analyze current German assertions about what constitutes appropriate European economic policy, amid the worsening Continental recession. We need to work backward. Germany fervently believes it must preserve its competitiveness, its fiscal rectitude and its spotless inflation record. On these key issues, therefore, Germans have no appetite for thinking collectively.

Accordingly, Germans reject, without analysis, assertions that Germany must take a different route, accepting continental bank bailouts and bank insurance, engaging in stimulus at home and acquiescing to somewhat faster gains for domestic wages. Instead, they label such proposed changes as blasphemy, and profess that these prescriptions are all wrong for Europe. All wrong, perhaps for Germany, but the only hope for Europe.

Guarda le mani, non ascoltare la bocca - Watch the hands, ignore the mouth

Conducting European policy, to preserve German precepts, over the last several years has returned Europe to recession and threatens the euro itself. The best hope for Europe going forward? Mario Draghi. Draghi's predecessor at the ECB, Jean Claude Trichet, embraced the German script with gusto, helping to put Europe into the dire state it finds itself in today. Mario Draghi, however, has twice engineered an end run of the Bundesbank. His willingness and ability to conduct monetary policy with an eye toward Europe, and an appreciation of the reality of the circumstances at hand, are Europe's best hope.

LTRO allowed banks to get long term funding. Outright monetary transactions, if implemented with gusto, can greatly reduce the penalty rates that now are imposed on periphery country borrowers. Both of these policies were vehemently opposed by the BUBA. Both would have been music to Hy Minsky's ears. Accordingly, we offer up some advice to Draghi. In the U.S., commitment to free markets and to the unwavering inflation fighting of the FRB has been standard rhetoric since Paul Volcker assumed the chair in 1978. That never stopped the Fed from responding aggressively to Minsky moments. Keep preaching BUBA orthodoxy, but continue to find ways to practice Minsky inspired depression fighting tactics.

[4] Eos, volume 90, number 3, 20 January 2009, Peter T. Doran

Even so, Dr. Draghi will sooner or later require the conversion of other policy-makers. A unified banking system with generalized deposit insurance is a must. That, not constitutional amendments demanding balanced budgets should be the first objective of Europe's policy elites. If a coordinated European fiscal policy is required, it is one of aggressive expansion in states like Germany and the Netherlands running current account surpluses balanced by longer-term programs of phased fiscal consolidation elsewhere. It is a tall order given the present starting point. We wish you the best.