Of Godley Geometry & the Fatal Deceit of the Eurozone

Or

Welcome to Austeria: Have a Nice GD 2.0!

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MacroStrategy Edge

Richebacher Letter

Levy Economics Institute

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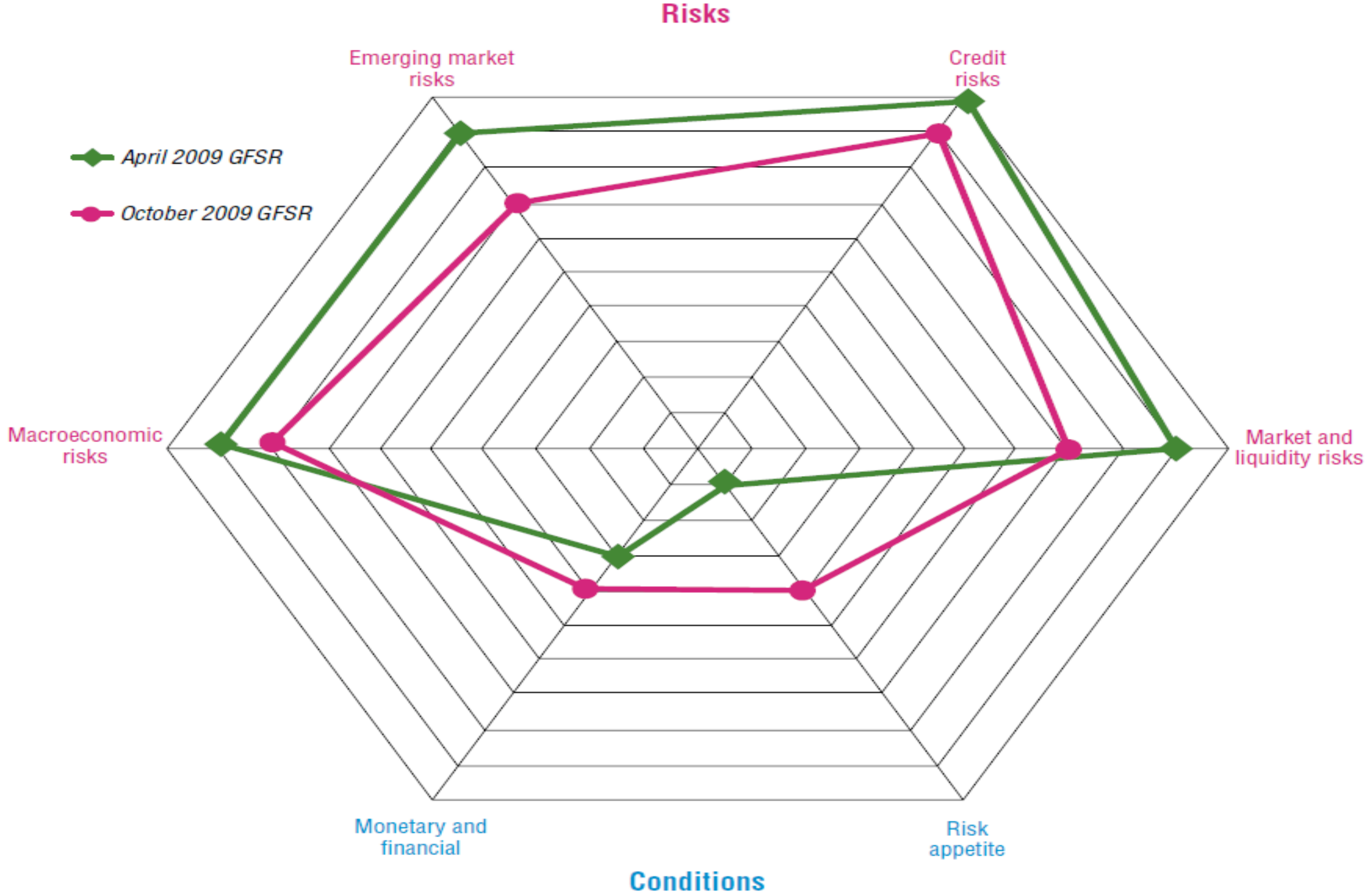
The Eurozone Predicament

- Investors and policy makers (still!) have a rather limited ability to perceive macrofinancial balances (MFB)
- A simple MFB approach reveals the eurozone is flirting with a Minsky Meltdown/Fisher Debt Deflation path
- Attempts at fiscal retrenchment are likely to prove self-defeating: the unrecognized Paradox of Public Thrift
- Fiscal retrenchment across the GIIPS will set off 2 contagion vectors via banks & trade to swamp core
- We are missing a price or policy adjustment mechanism to force current account surplus nations to reinvest in productive capacity in CU deficit nations (EU & Global)

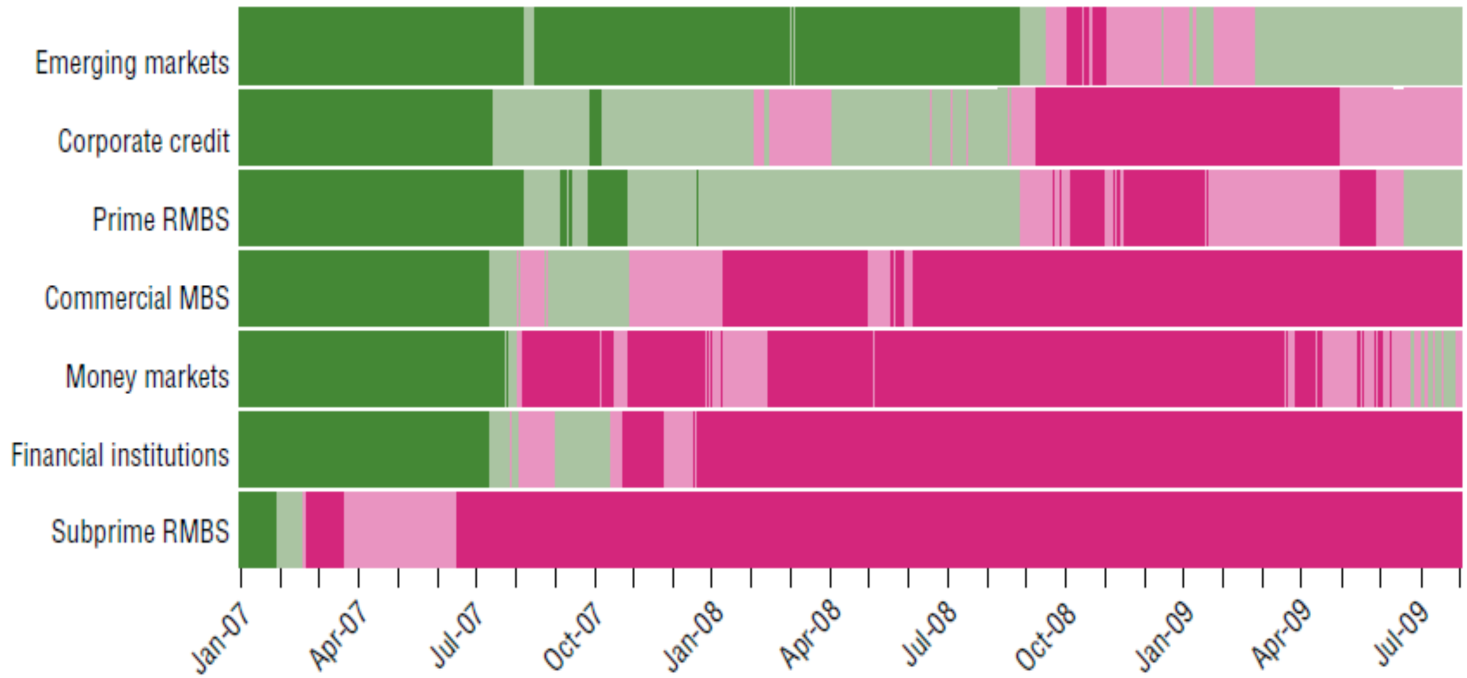
IMF Financial Stability Tools

Figure 1.1. Global Financial Stability Map



IMF Financial Stability Tools

Figure 1.2. Heat Map: Developments in Systemic Asset Classes



Source: IMF staff estimates.

Note: The heat map measures both the level and one-month volatility of the spreads, prices, and total returns of each asset class relative to the average during 2003–06 (i.e., wider spreads, lower prices and total returns, and higher volatility). That deviation is expressed in terms of standard deviations. Dark green signifies a standard deviation under 1, light green signifies 1 to 4 standard deviations, light magenta signifies 4 to 7 standard deviations, and dark magenta signifies greater than 7 standard deviations. MBS = mortgage-backed security; RMBS = residential mortgage-backed security.

Evidence the Mainstream Approach to Financial Stability Assessment Fails

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FINANCIAL STABILITY IN ICELAND

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Evidence the Mainstream Approach to Financial Stability Assessment Fails

There are three traditional routes to financial instability that have manifested themselves in recent financial crises: 1) financial liberalization with weak prudential regulation and supervision, 2) severe fiscal imbalances, and 3) imprudent monetary policy. None of these routes describe the current situation in Iceland. The economy has already adjusted to financial liberalization, which was already completed a long time ago, while prudential regulation and supervision is generally quite strong. Fiscal imbalances are not a problem in Iceland: quite the opposite, with Iceland having an

Evidence the Mainstream Approach to Financial Stability Assessment Fails

The analysis in our study suggests that although Iceland's economy does have some imbalances that will eventually be reversed, financial fragility is currently not a problem, and the likelihood of a financial meltdown is low. However, the possibility that multiple equilibria might occur suggests that policy measures to bolster confidence in the Icelandic economy and financial system would be beneficial. We suggest four such measures: 1) financial supervision might be more effective if it

What's Missing from Standard Applied Financial Stability Analysis?

- Sustained flow imbalances need to be adequately tracked for aggregate sectors, industries, income distributions, and large institutions

- Flow imbalances build up as stock disequilibria on balance sheets over time

- Therefore watch fast, large, persistent balance sheet growth, especially when driven by rapid credit flows

- Do not assume investors, rating agencies, or market based risk indicators are accurately reflecting "true" fundamental risk conditions (remove EMH bias)

The Financial Balance Approach

Aggregate Income = Aggregate Expenditure
Y = E

Total Saving = Total Investment
S = I

True for economy as a whole during any accounting period

But not necessarily true for any one sector

The Financial Balance Approach

Divide the economy into three sectors:

- Government
- Domestic Private (Household and Business)
- Foreign

Sector Financial Balance SFB = Y – E for that sector
(or equivalently, S – I)

Sector Financial Balance can be in:

- Surplus: $Y > E$, $S > I$ Accumulate financial assets
- Neutral: $Y = E$, $S = I$
- Deficit: $Y < E$, $S < I$ Issue financial liabilities

The Financial Balance Approach

3 Sector Financial Balances (FB):

- Government FB = T – G
- Foreign FB = M – X, or (-1) (Current Account Balance)
- Domestic Private Sector FB = (Sh + Sb) – (Ir + Inr)

Sum of sector Financial Balances must net to zero:

DPSFB + GFB + FFB = 0

or

DPSFB + GFB – CUB = 0

The Financial Balance Approach

- Changing the FB for one sector has implications for the remaining sectors

- Sector balances cannot be analyzed in isolation – it all has to add up

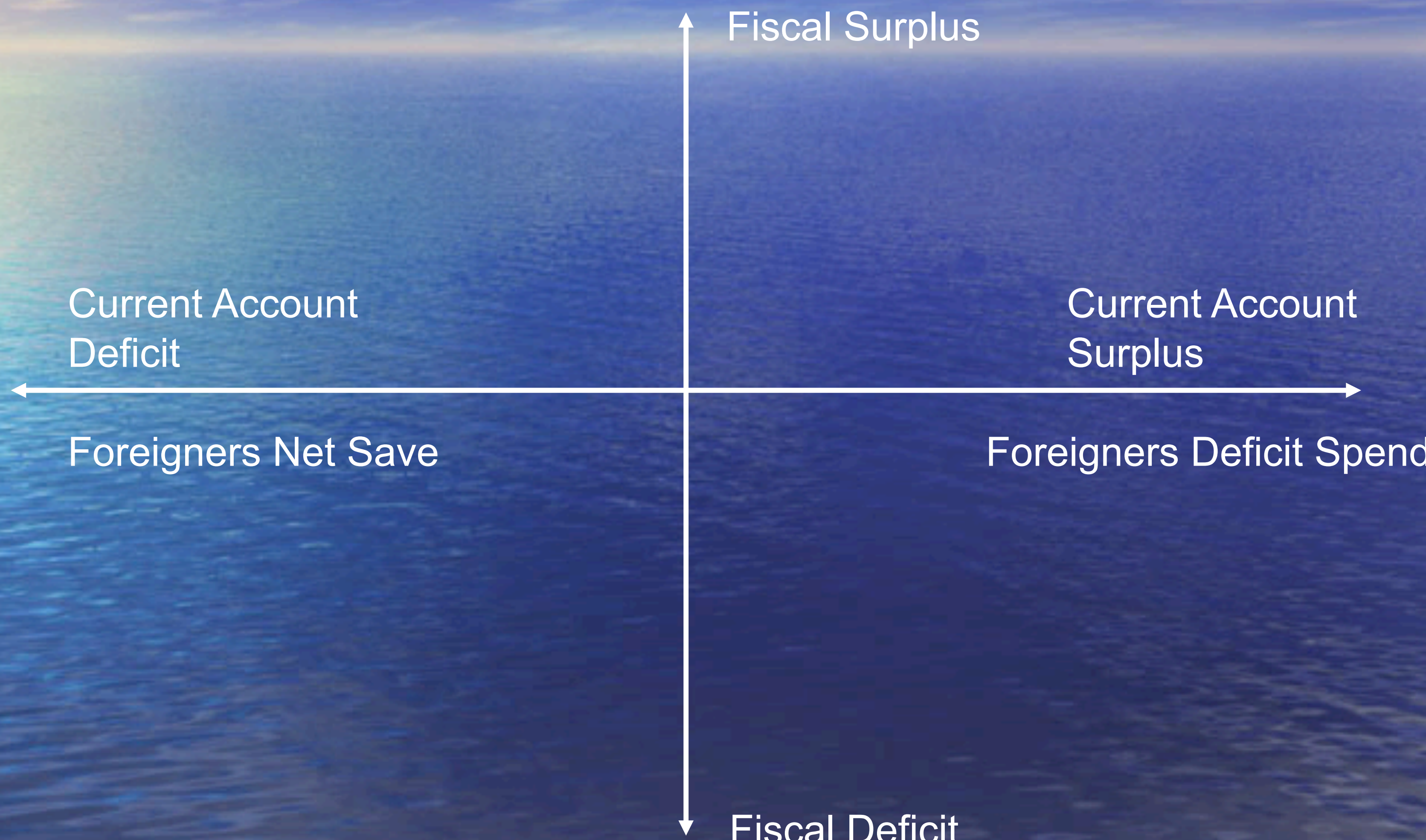
The Financial Balance Approach

Domestic Private Sector Financial Balance increases when:
- Government runs a deficit
- Current account in surplus
- CUB > GFB

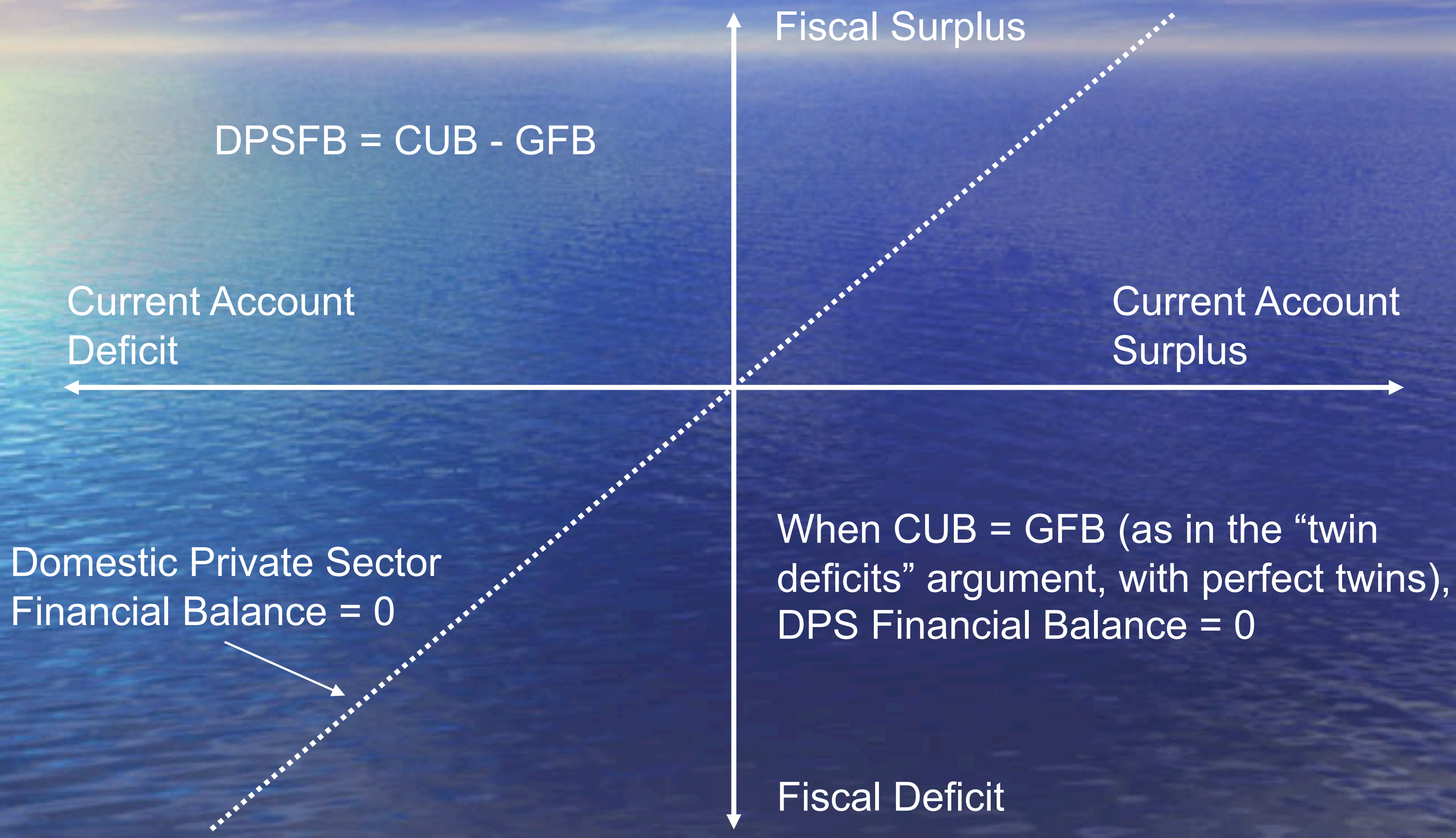
DPSFB decreases when:
- Government runs a surplus
- Current account in deficit
- CUB < GFB

DPSFB + GFB – CUB = 0
DPSFB = CUB – GFB

Government & Foreign Sector Financial Balances

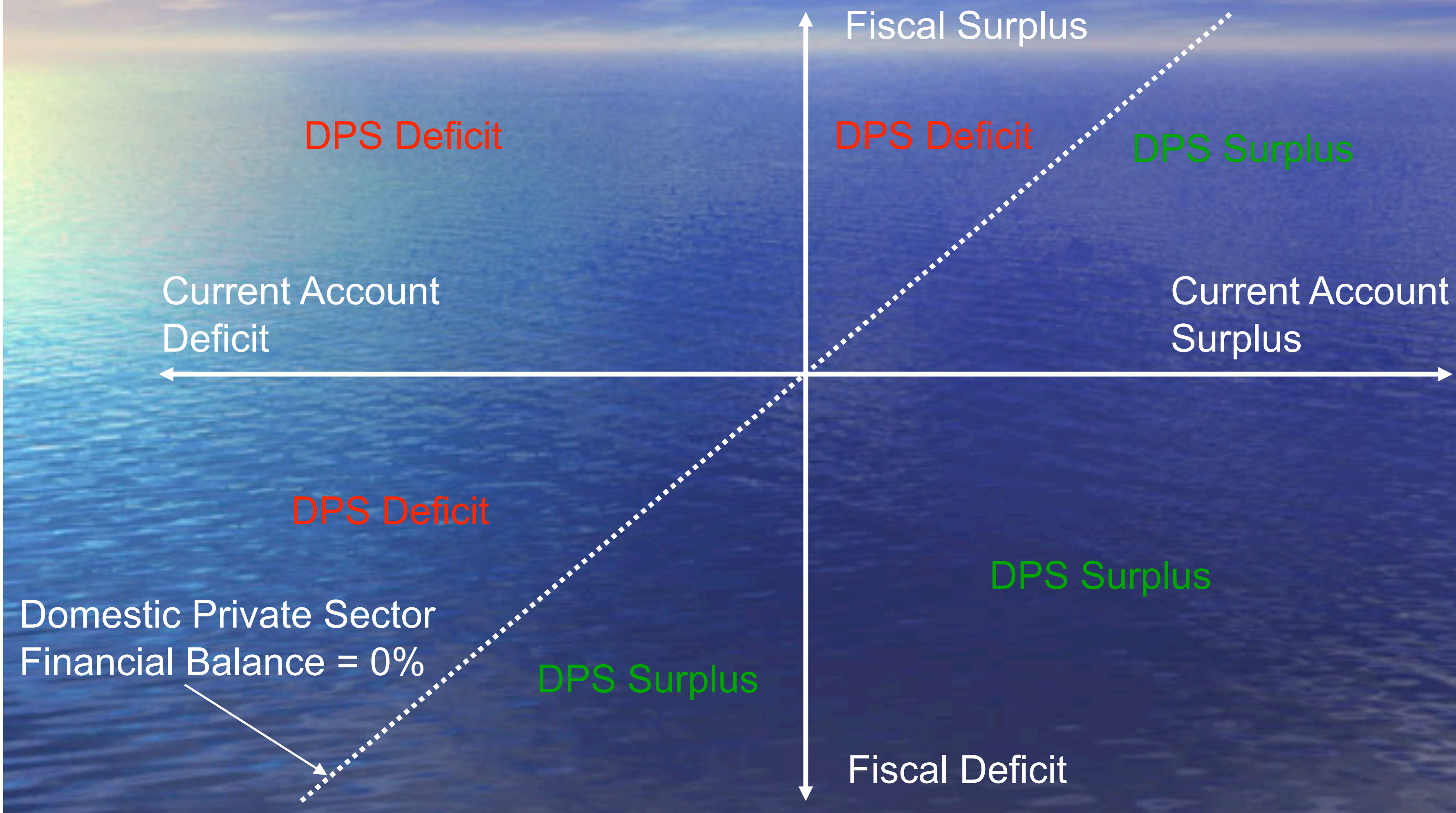


Adding the Domestic Private Sector Financial Balance

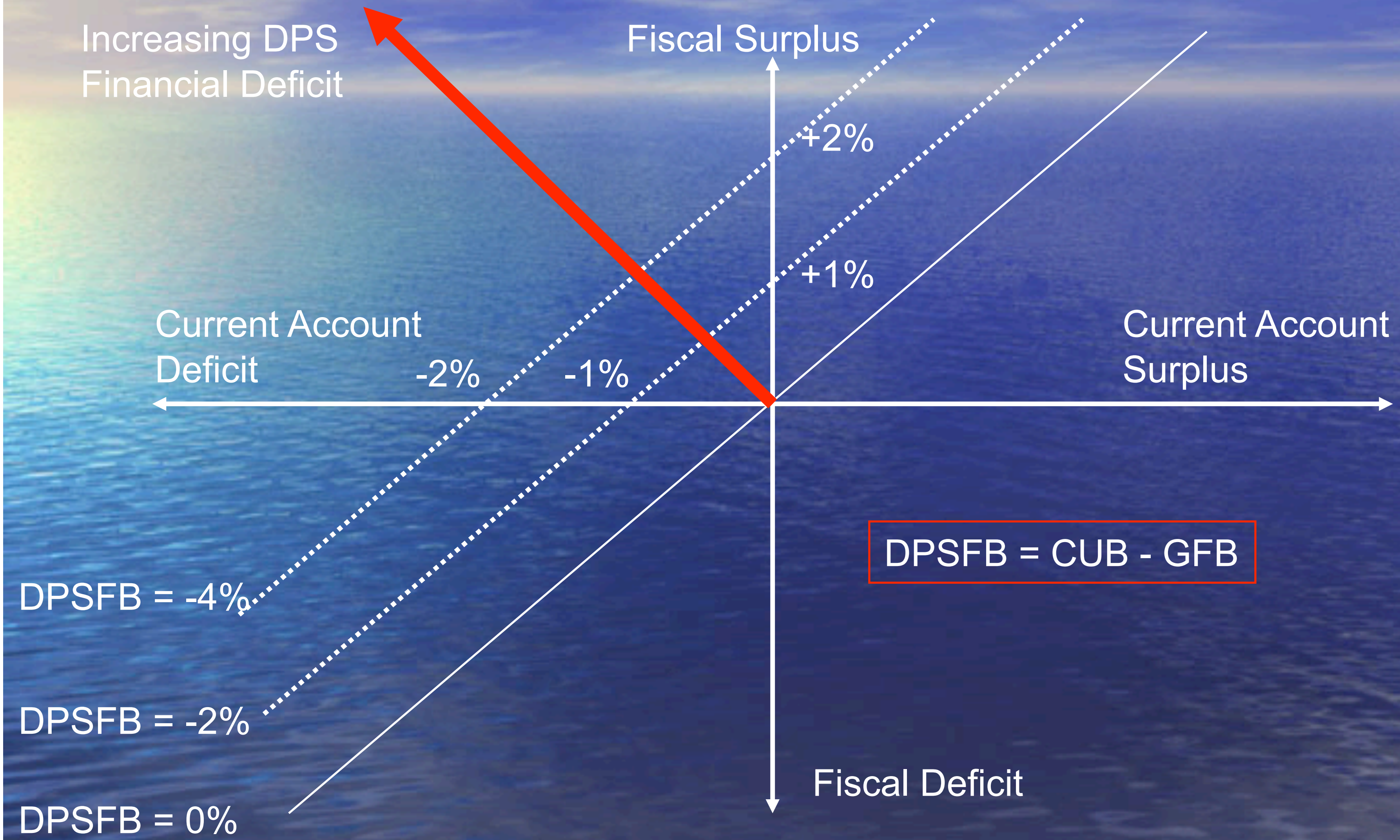


3 Sector Financial Balances Map

Domestic Private Sector Financial Balance = Current Account Balance – Fiscal Balance



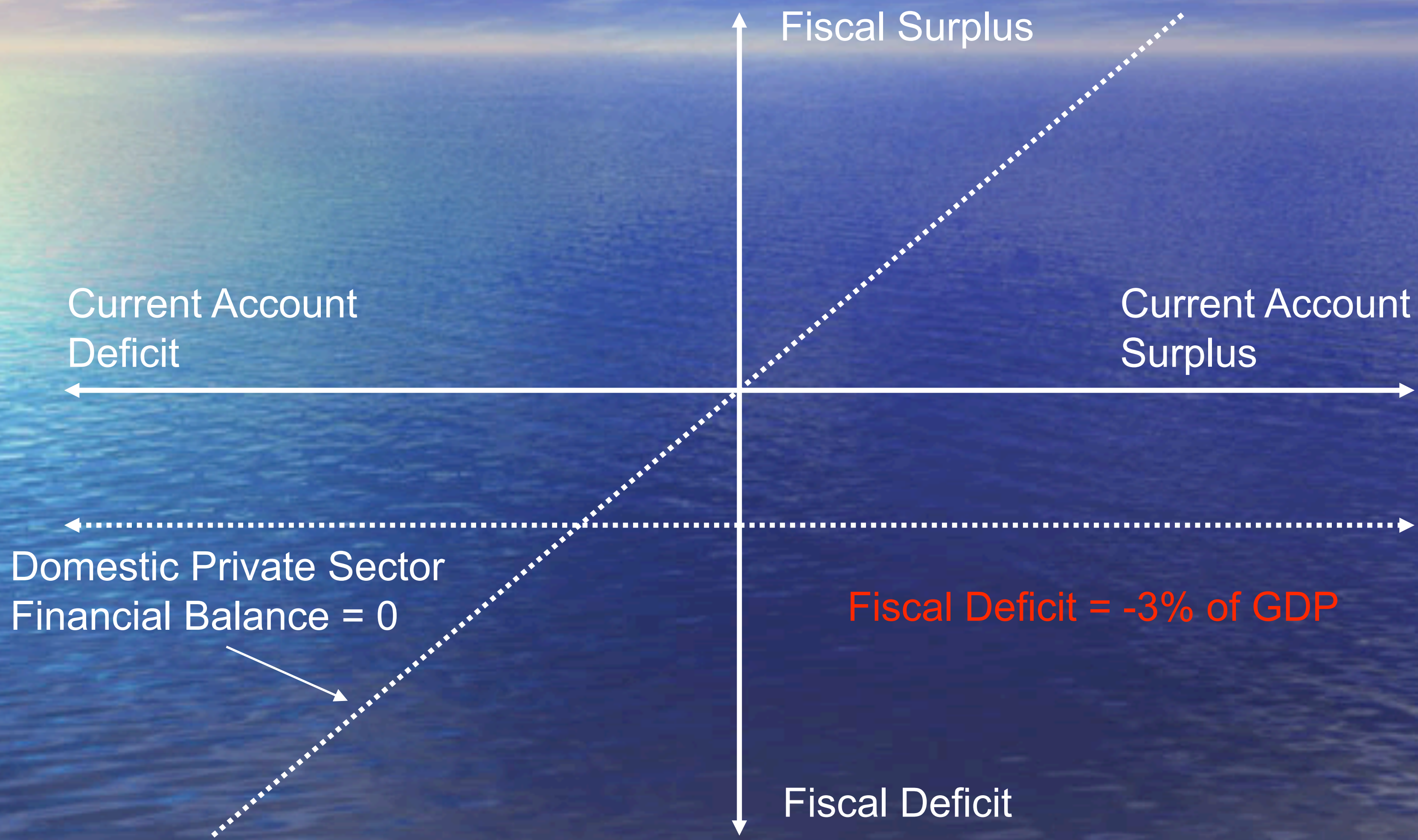
Domestic Private Sector Deficit



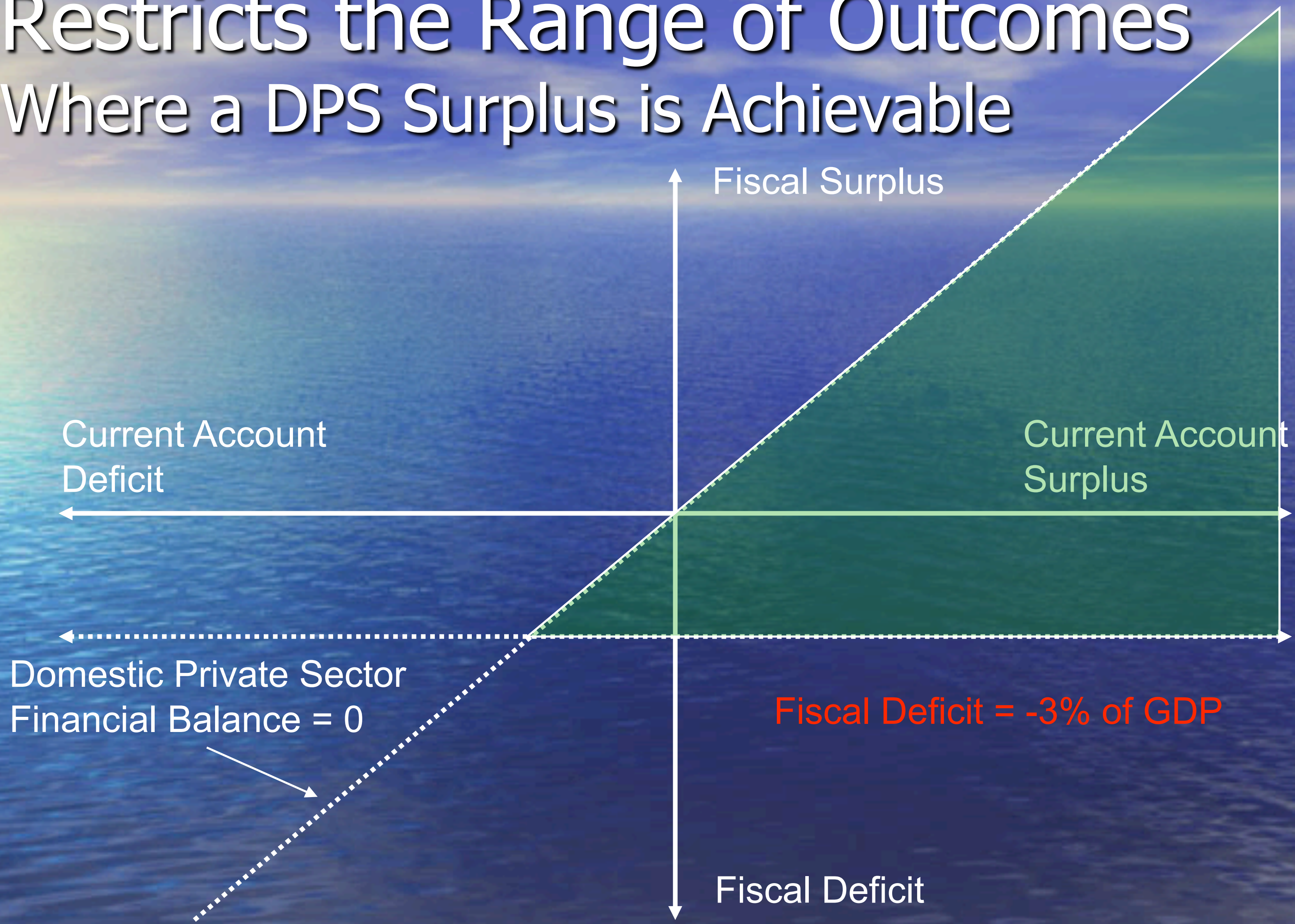
The Financial Balance Approach

- In order to run a Government surplus
- And a Domestic Private Sector financial surplus
- So that both sectors can service and reduce debt
- Need a Current Account surplus > Government surplus
- This is how Asia can run fiscal surplus and achieve high private net saving (acquire financial stability in 1 nation)
- Reducing a fiscal deficit will erode the DPSFB unless the current account balance improves in tandem with GFB (need strict assumption: identical "twin" deficits)

Add a Fiscal Policy Constraint

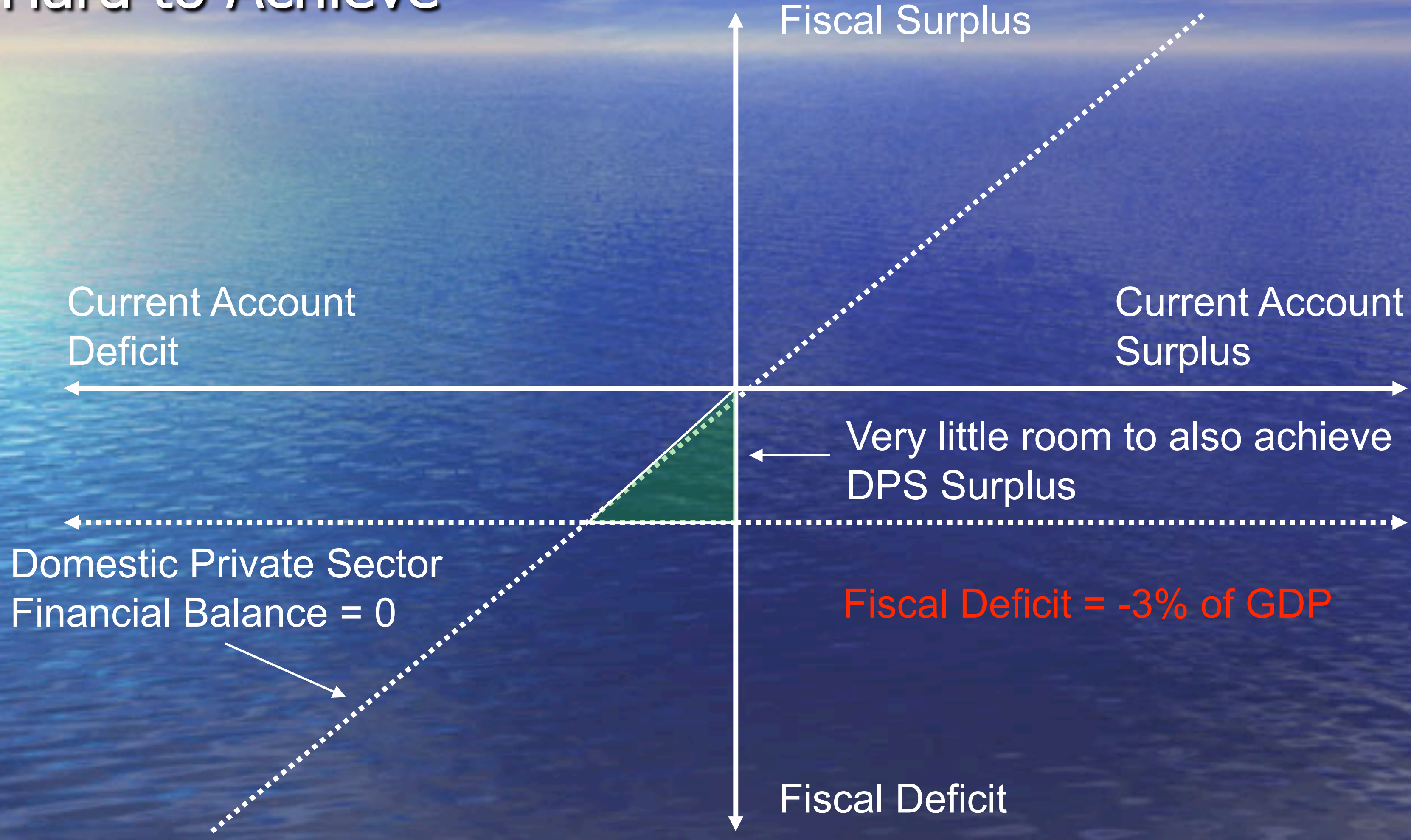


Restricts the Range of Outcomes
Where a DPS Surplus is Achievable

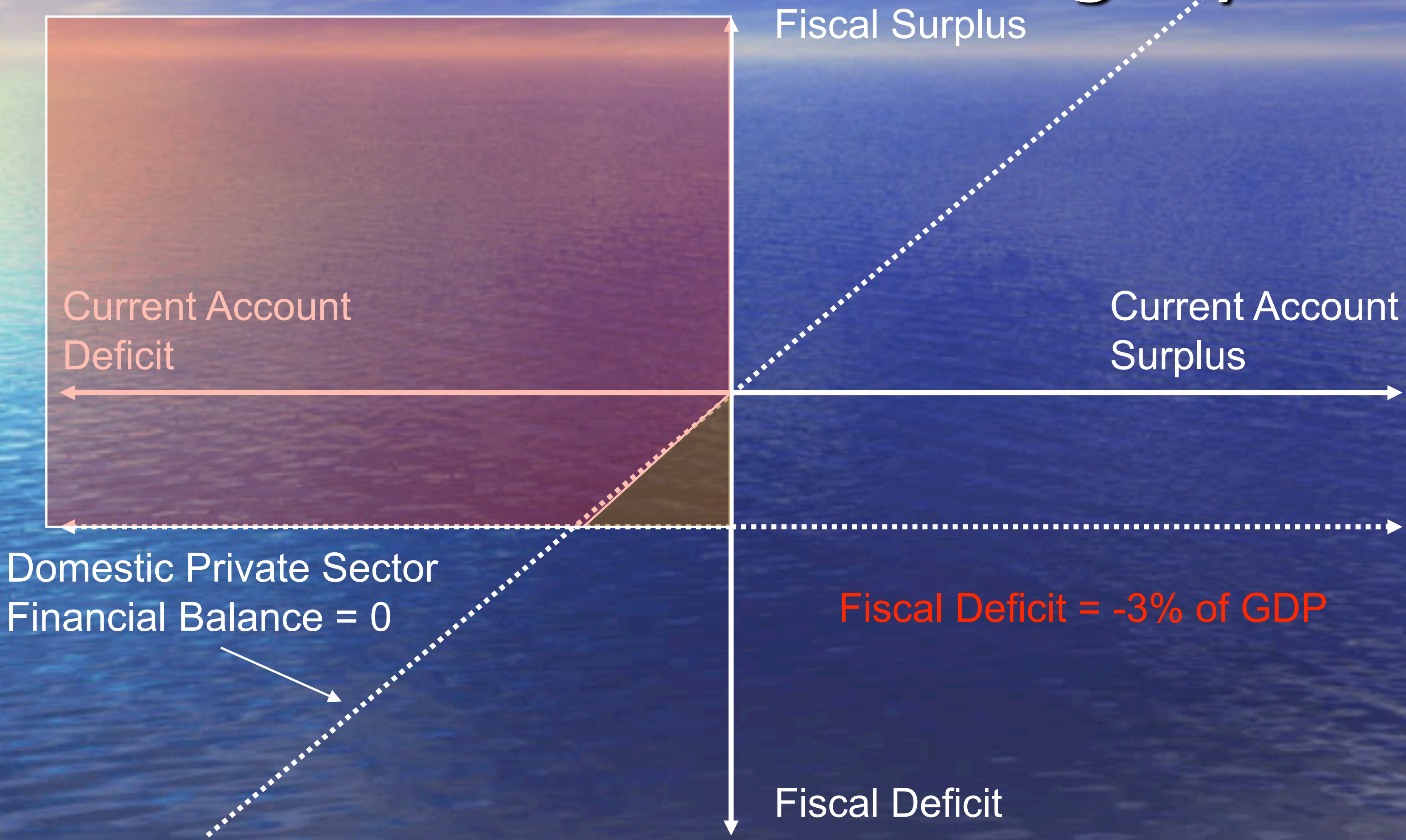


The EMU Triangle:

FX Policy Constrained, Current Account Surplus Hard to Achieve



EMU & SGP Can Increase Odds of Private Sector Financial Fragility



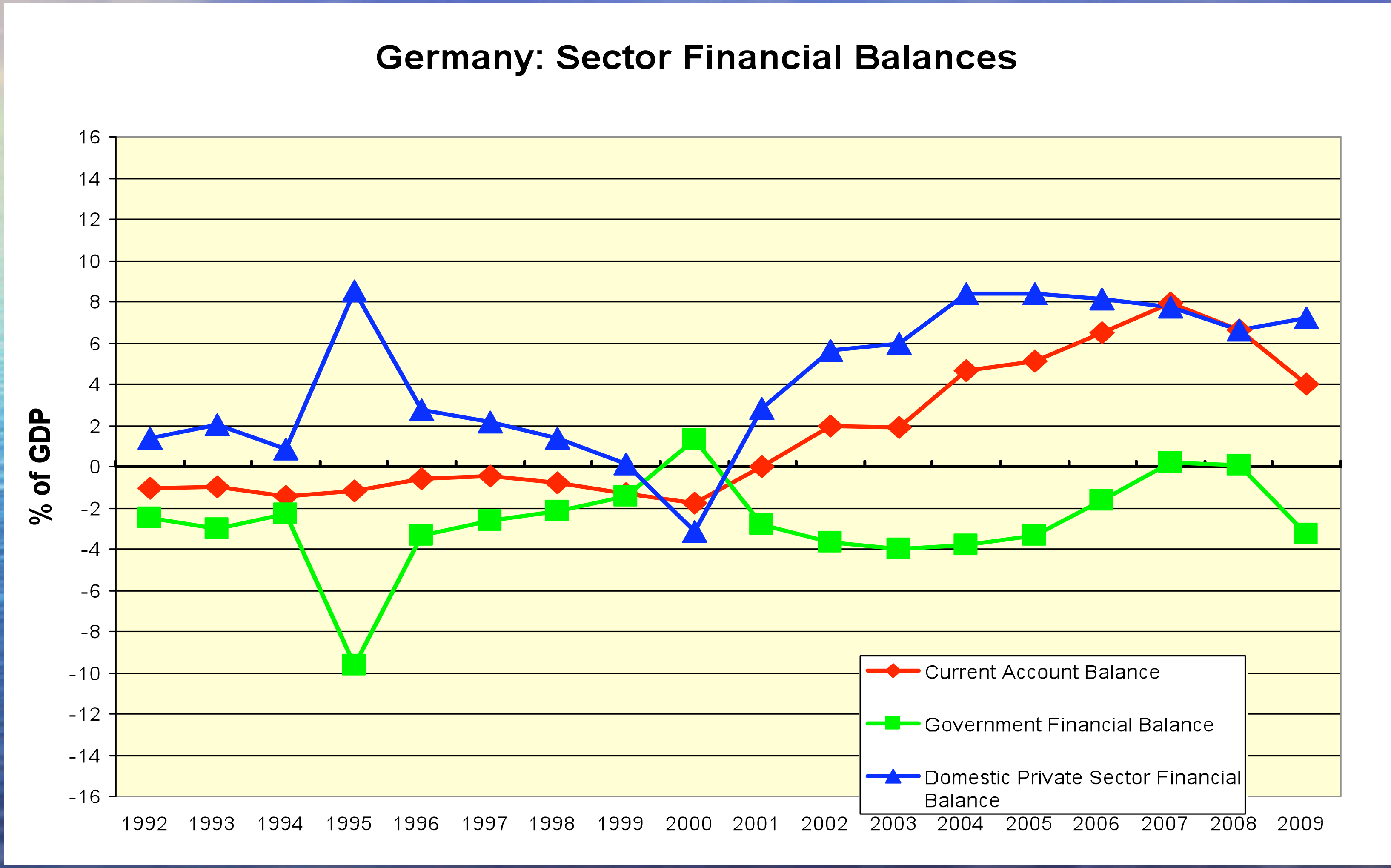
The Eurozone Predicament:
3 Policy Straitjackets & Market Fundamentalism

- Common currency means varying nominal exchange rate is not available to any one nation
- Fiscal policy is subject to 3% fiscal deficit floor with fines
- Monetary policy is subject to one size fits all committee
- Burden of adjustment is largely shifted onto relative prices, private income deflation, and product innovation
- Why? Because markets are presumed to gravitate to full employment, utility maximizing equilibrium best on their own, undistorted by "artificial" policy interventions

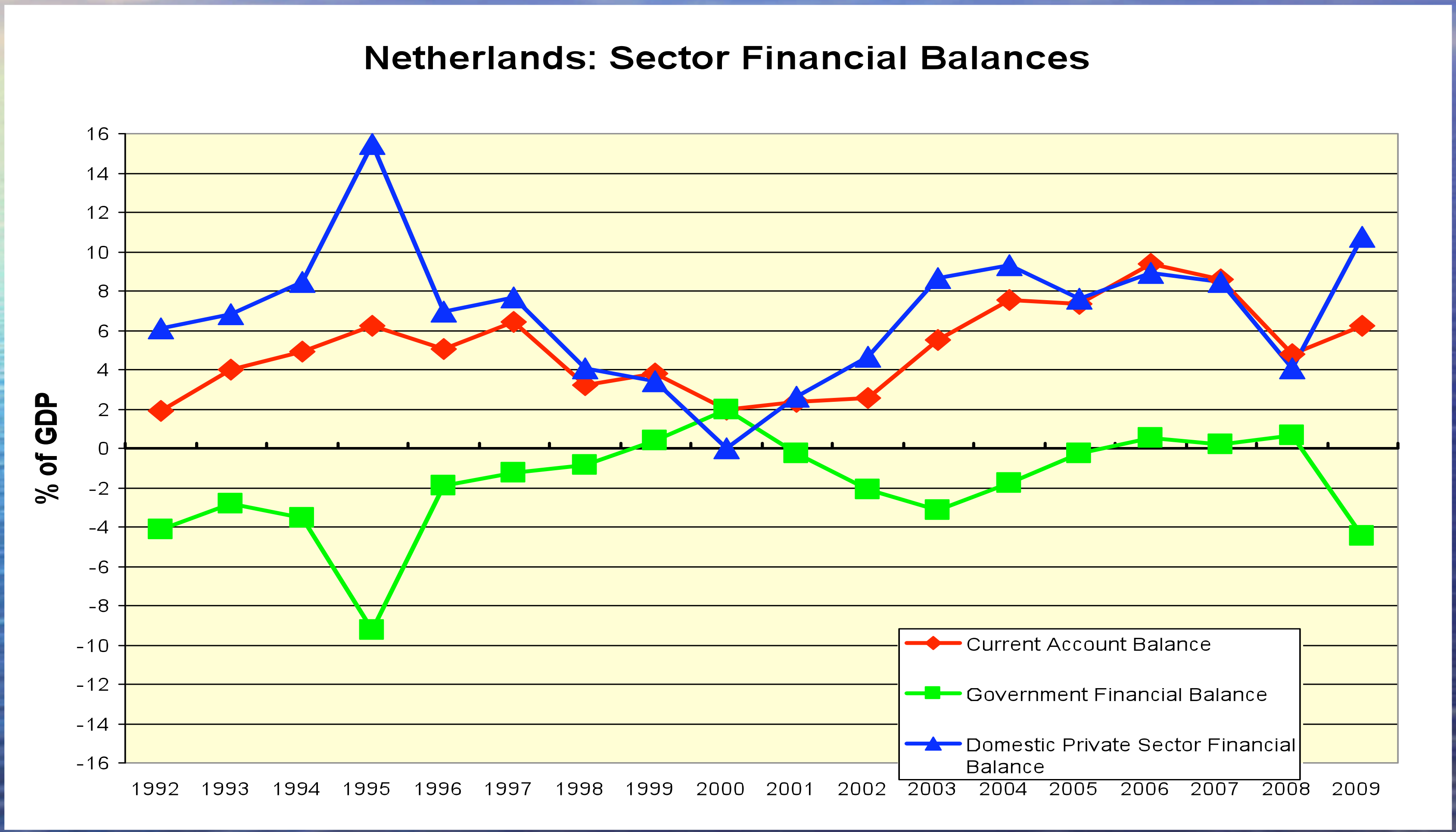
Applied Financial Stability Analysis: The Eurozone Predicament

- If you rapidly reduce fiscal deficits in eurozone, you will also reduce private sector net saving
- More difficult for private sector to service & reduce debt
- Quest for fiscal sustainability in eurozone implies bank risk higher than government risk as private loans sour
- Unless maxi-depreciation can produce large increase in trade balance for region as a whole, otherwise:
- Peripheral eurozone trade balance swing trips up German, Dutch exporters, unless new markets found

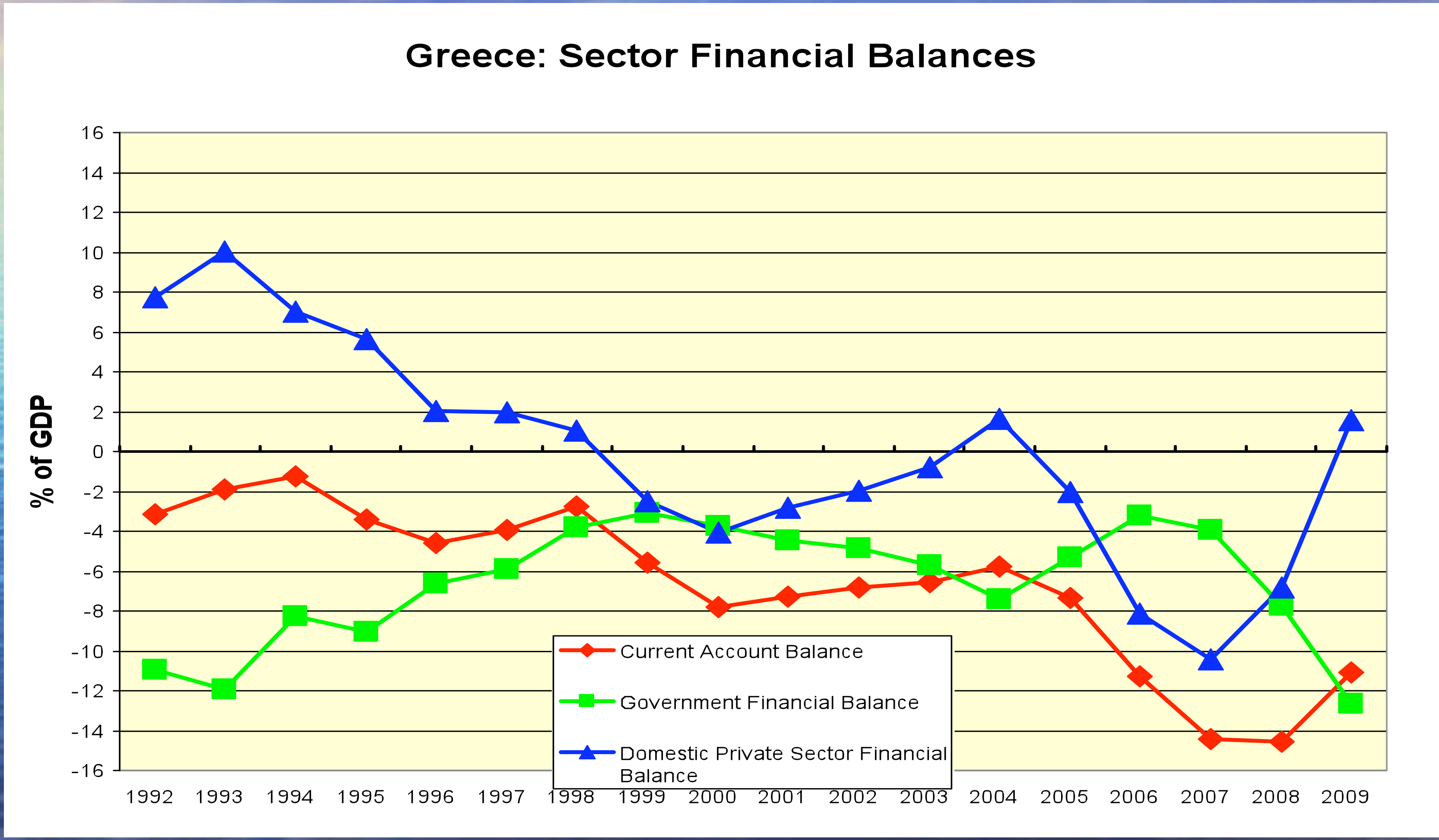
The Paragons of Virtue



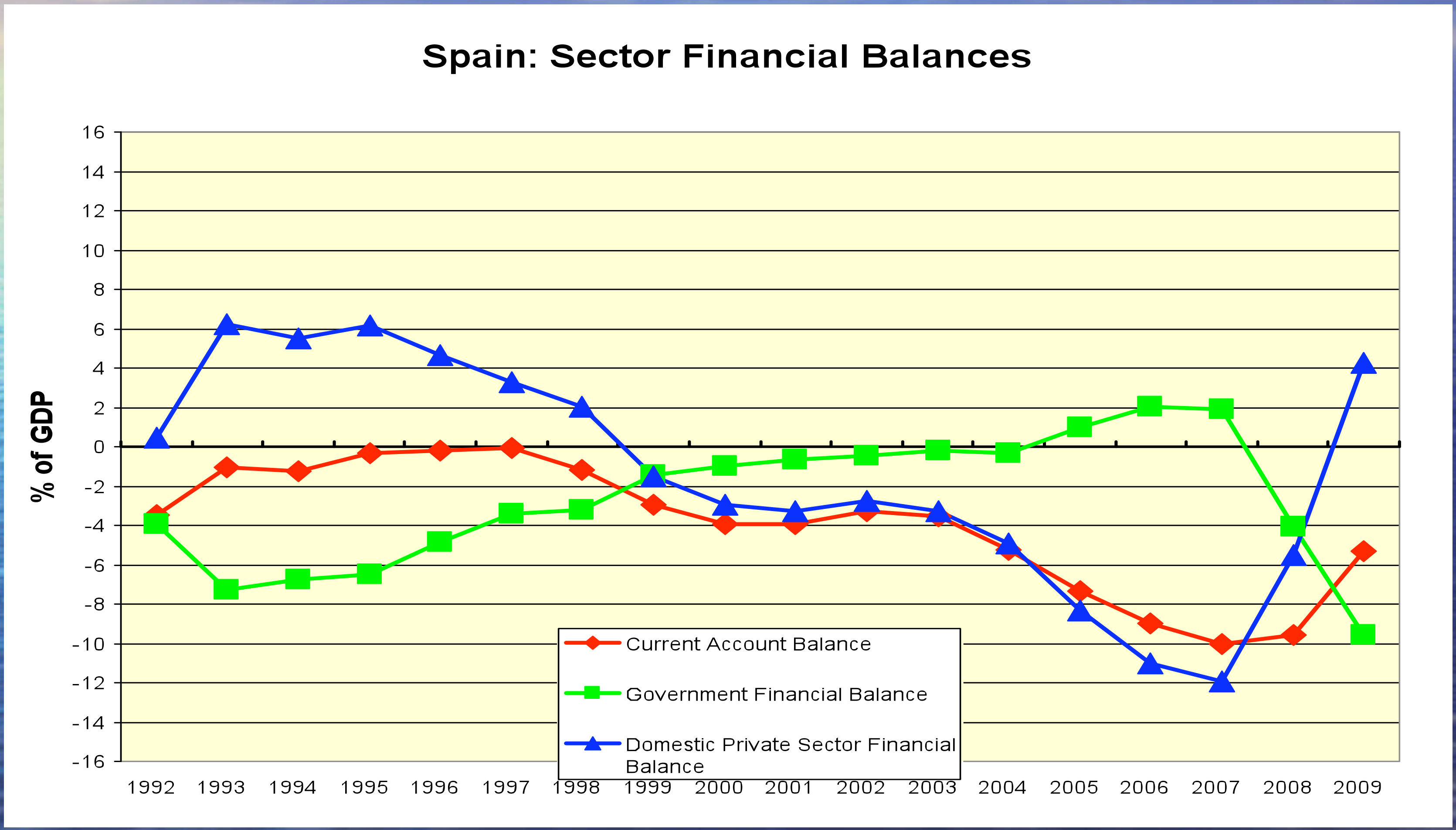
The Paragons of Virtue



The Poster Boys of Sloth

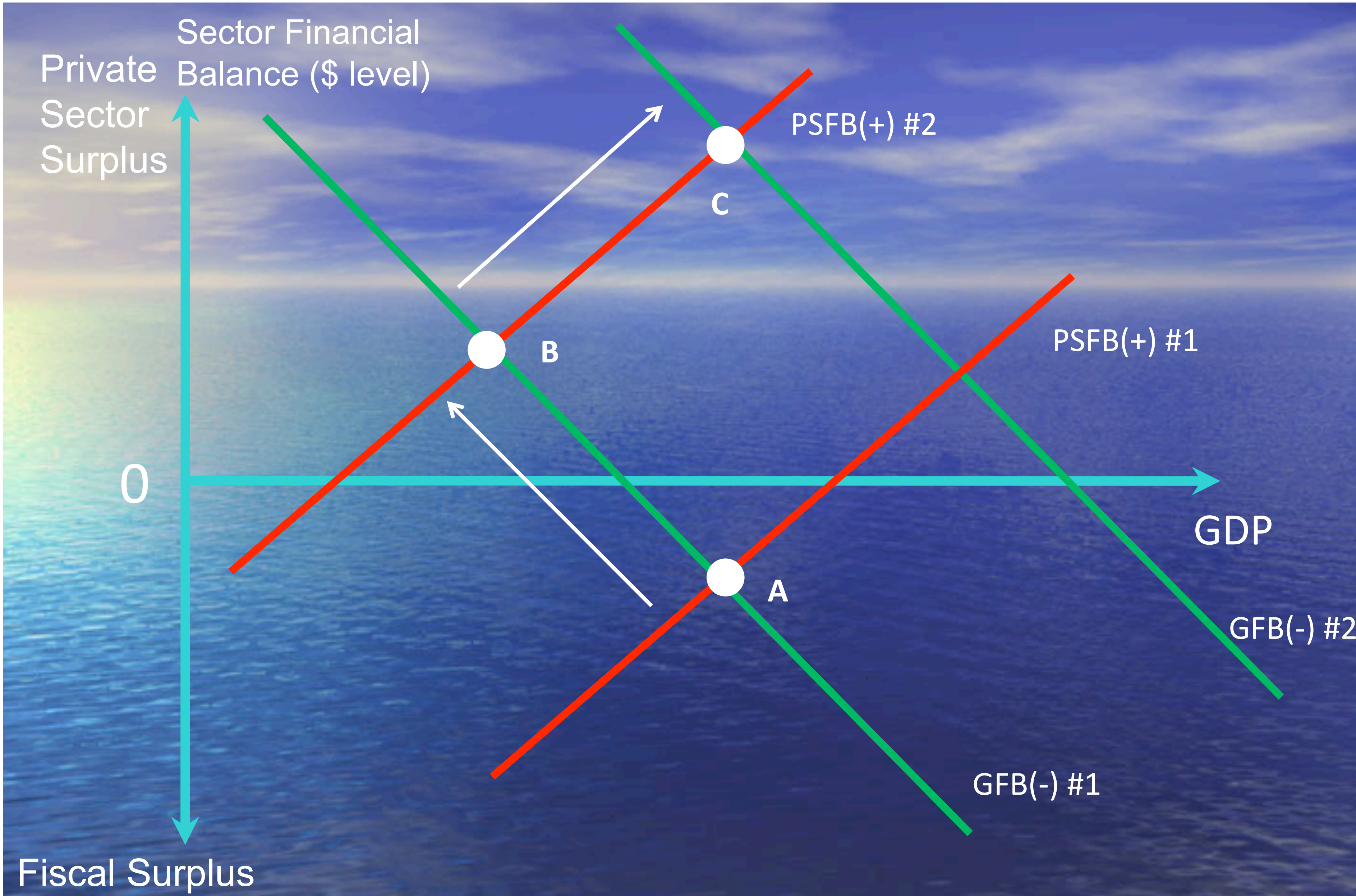


The Poster Boys of Sloth



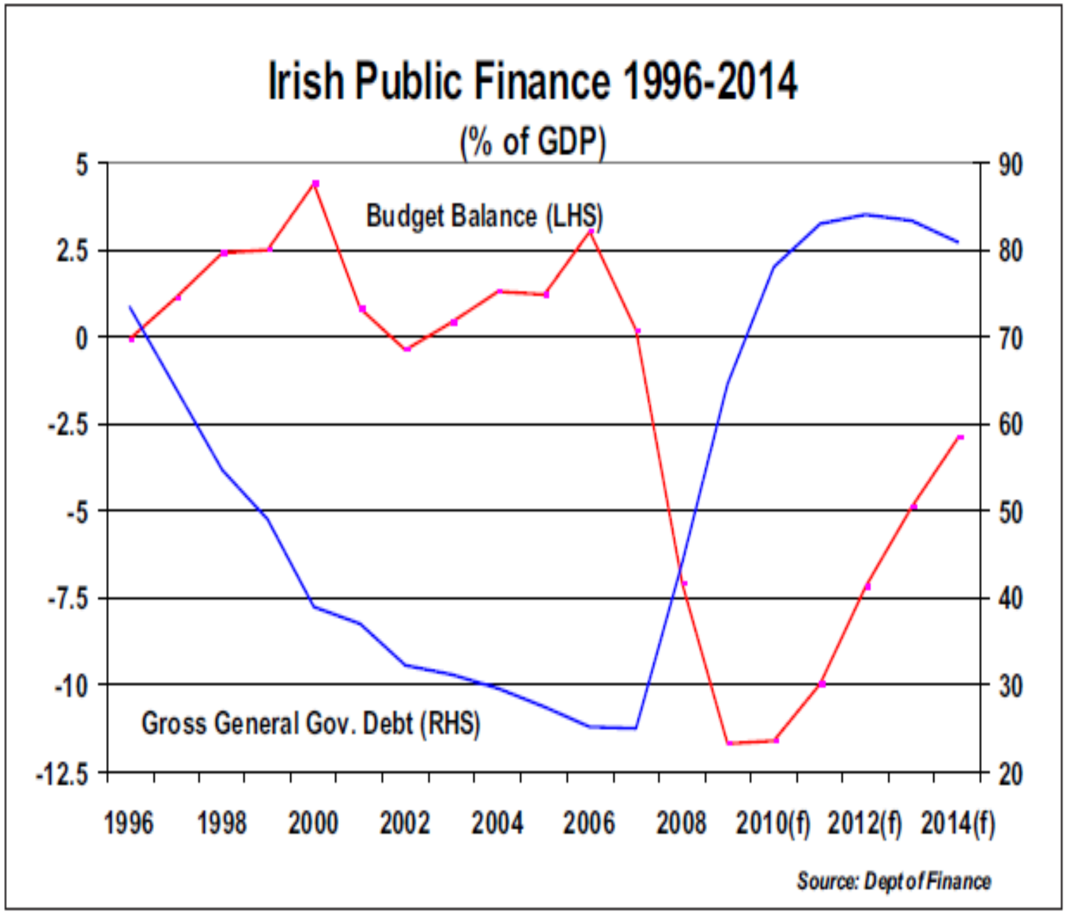
The Paradox/Vortex of Public Thrift

- Tax hikes suck cash flow out of private sector
- Expenditure cut crimp cash flow into hh, firms
- Domestic private income shortfalls lead to contraction of profits, debt distress, signaling production cutbacks
- Tax revenues come up short
- Automatic stabilizers raise expenditures
- Budget deficit misses required target levels
- Larger cuts are demanded, further undermining private cash flows
- Wash, rinse, repeat
- Only way out is if domestic private income deflation turns current account balance up enough before private debt distress drags the economy into Fisher vortex (“internal devaluation” route with a knife edge)



Post Bubble Income Stabilization in a Financial Balance Framework

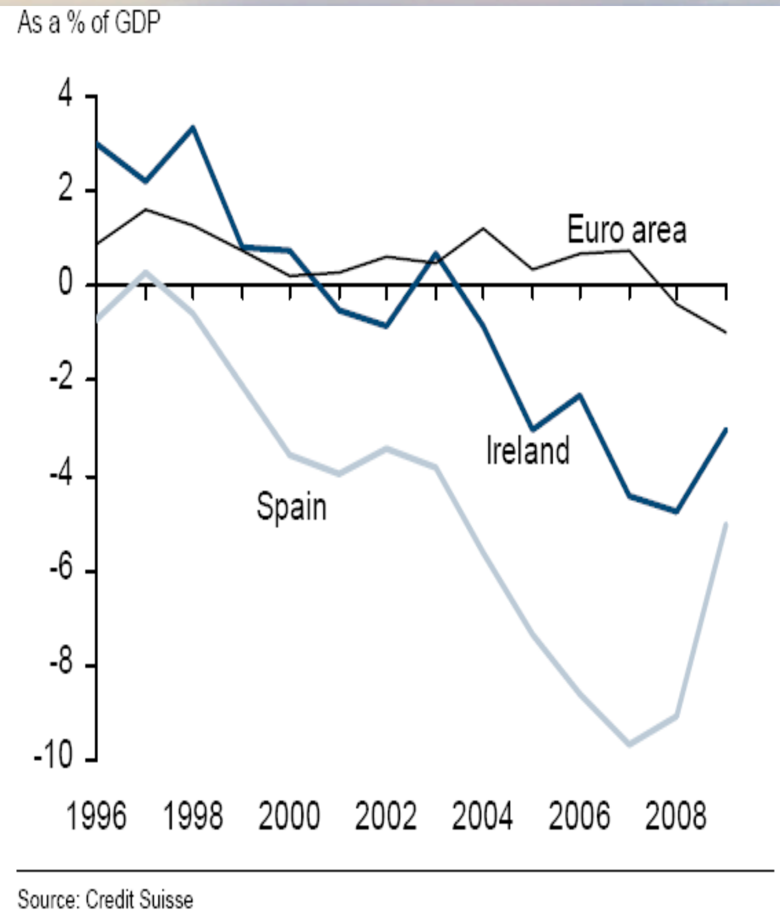
The Paradox of Public Thrift: Ireland

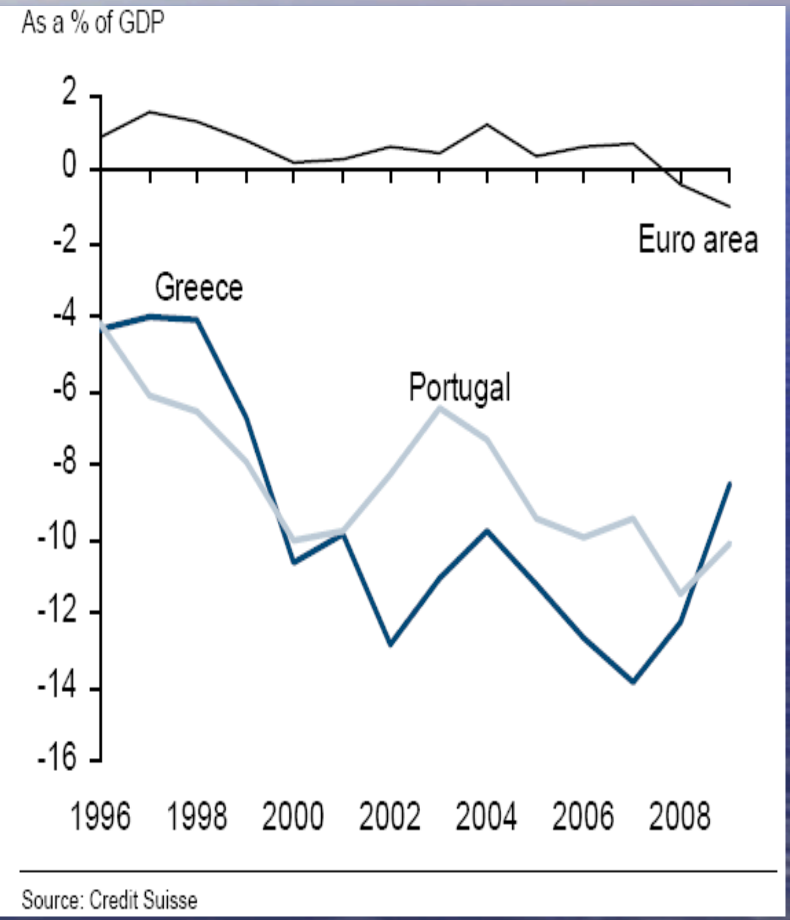


BUDGET 2010

(€ Million)	2009 Projected Outturn	2010 Budget Target	% Change
Current Spending	**45,520**	**47,123**	**+3.5**
of which			
(i) Central Fund	5,152	6,932	+34.5
(ii)Supply Services	40,368	40,192	-0.4
Current Revenue	**33,404**	**33,405**	**0.0**
of which			
(i) Tax	32,570	31,050	-4.7
(ii) Non-Tax	834	2,355	182.4
Current Budget Deficit	**12,116**	**13,718**	
Capital Borrowing	**13,145**	**5,062**	
Exchequer Deficit	**25,260**	**18,780**	
Gen. Gov. Deficit (% of GDP)	**19,260** (11.7%)	**18,720** (11.6%)	

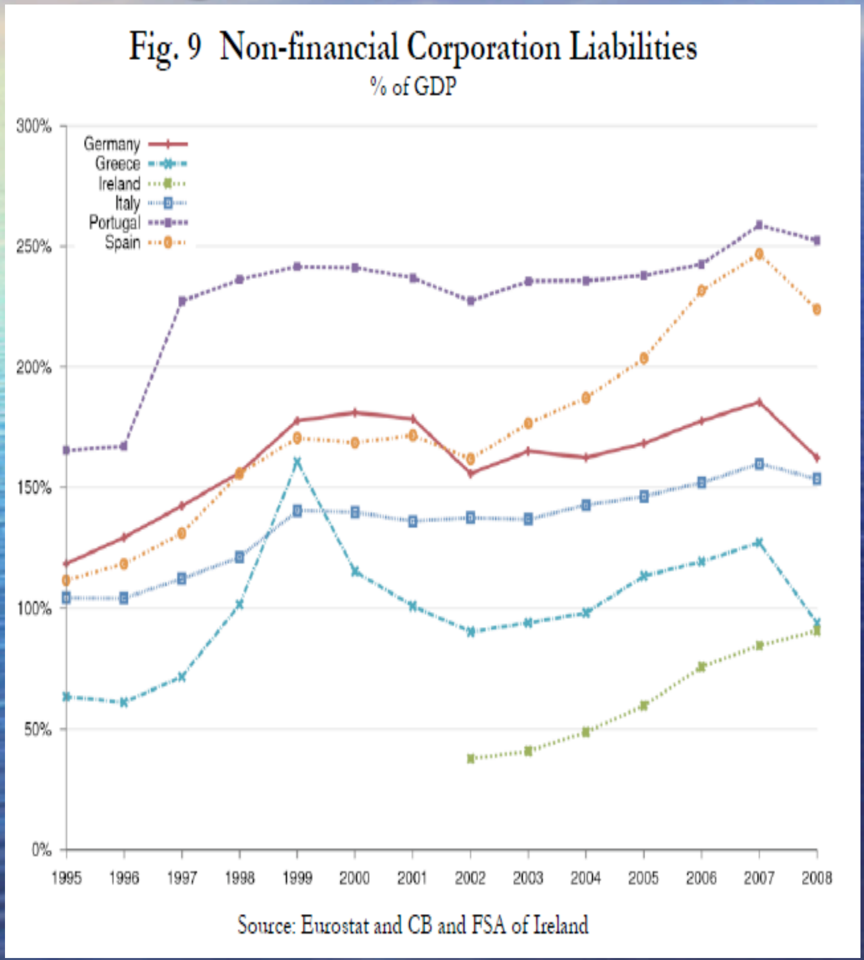
Contagion Vector 1: Trade
Current Account Balances in the Peripheral Eurozone Nations

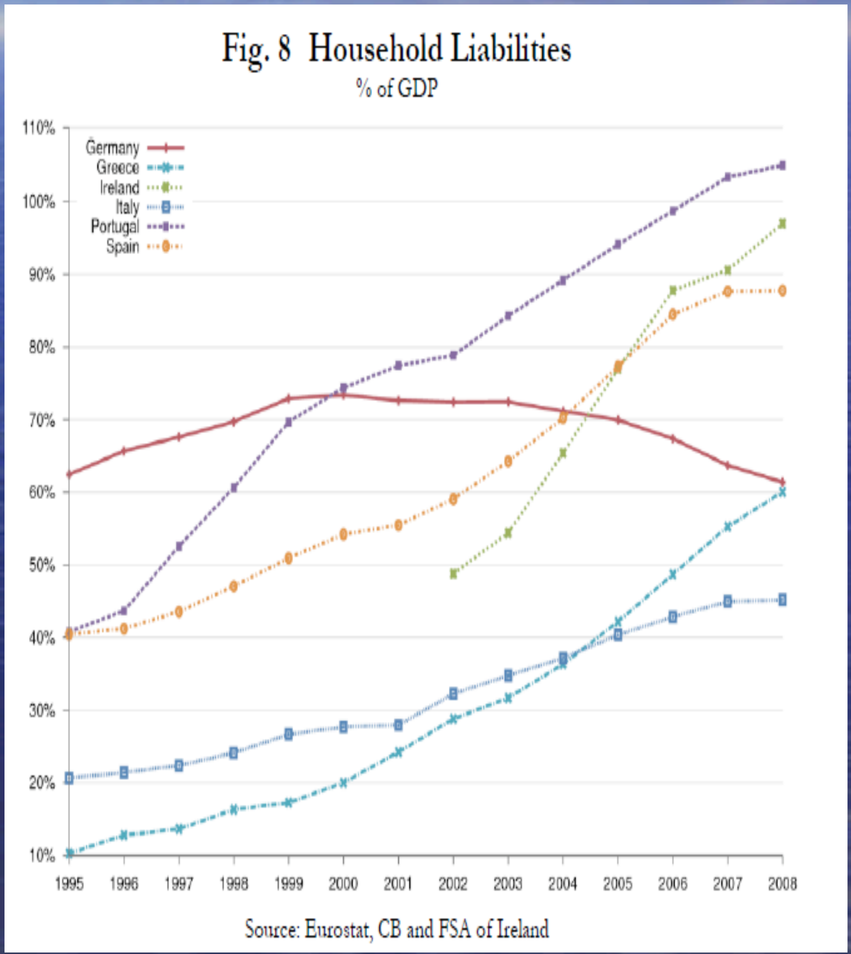




Contagion Vector 2: Private Debt

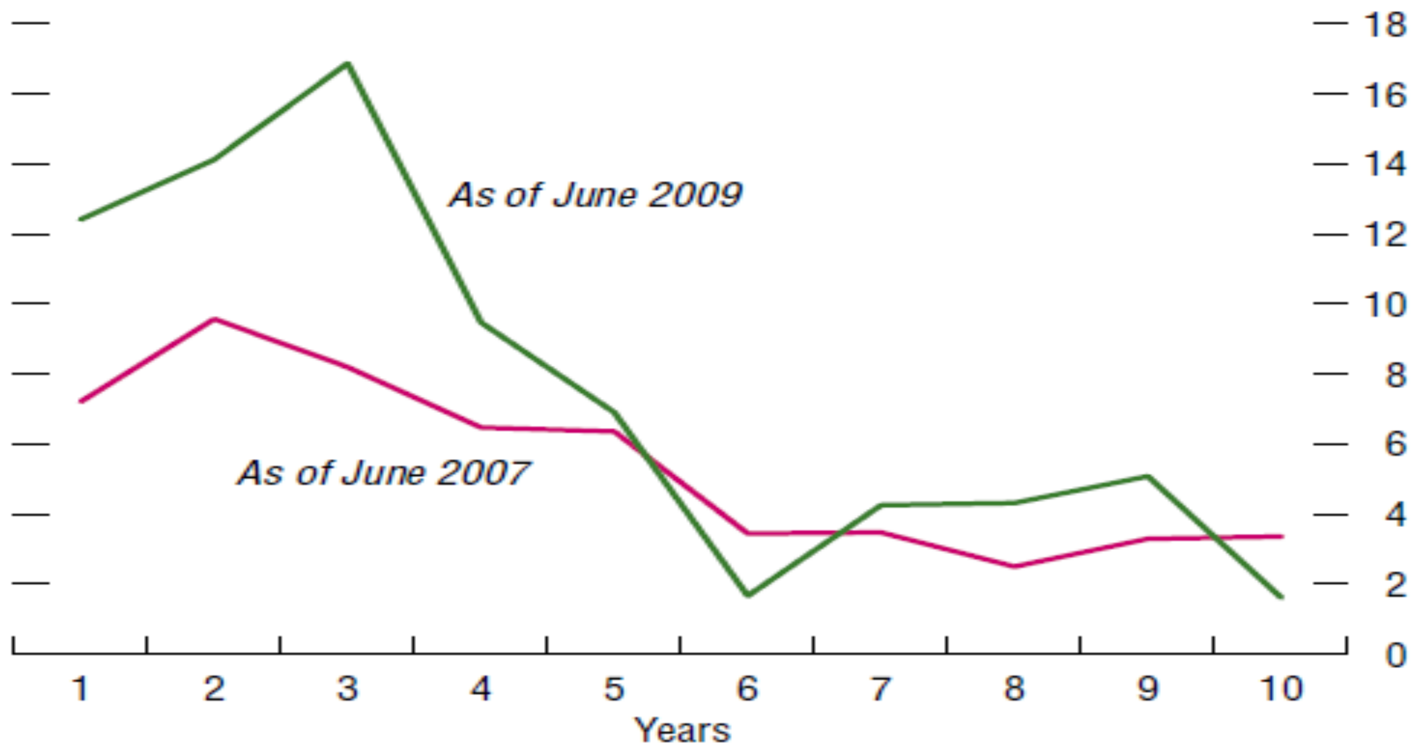
Private Sector Debt/Income Ratios are High and Rising in the eurozone





Distribution of Maturing Bank Debt

Figure 1.13. Mature Market Banks: Bond Debt Maturity Structure
(Percent of debt maturing over 12-month periods against initial outstanding)



Possible Routes Forward

- Public debt restructuring (or default)
- Maxi-depreciation of the euro
- Sustainable current account surplus recycling through the European Investment Bank
- Repudiation and revocation of the (In)Stability and (Lack of) Growth Pact
- Go for growth fiscal stance: ELR + Public/Private Investment to return to FE growth path
- ECB allowed to purchase public debt up to some inflation ceiling constraint
- Argentina post 2001 provides a historical precedent

Conclusions

- Any serious assessment of financial stability needs an internally consistent stock/flow analytical approach
- We cannot coherently examine fiscal policy options without analyzing their implications for the financial balances of other sectors
- There can be a paradox of public thrift if trade balance does not have a high income elasticity
- Imposing a fixed fiscal deficit to GDP floor makes it harder to achieve or sustain private sector net saving objectives, especially in post bubble periods

Conclusions

- The domestic private and government sectors cannot deleverage at the same time without a large, sustained increase in the trade (or current account) balance
- By constraining the fiscal policy and nominal exchange rate options available to Eurozone nations, EMU & SGP together raise the odds of financial fragility rupturing domestic private sectors if trade surplus is not achieved
- Since European banks are more highly leveraged, the pursuit of fiscal sustainability may prove unsustainable if it leads to more private debt distress and bank losses

The Death of the Dismal Science, The Launch of a Life Affirming Economics

"For if we consistently act on the optimistic hypothesis, this hypothesis will tend to be realized; whilst by acting on the pessimistic hypothesis we can keep ourselves for ever in the pit of want."

J. M. Keynes, EIP, Nov. 8, 1931

Towards a Life Affirming Economics Rather than a Fraudulent, Looting Economics

MacroStrategy Edge

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