EUROPEAN FINANCIAL POLICY, AS IF BANKING MATTERED

(Further Notes on the Crisis in the Euro-zone)

Jan Toporowski*

1. At the heart of modern finance capitalism lies the credit mechanism that accommodates the expansion of economic activity in a boom, and obstructs that activity with debt deflation in a recession. Since Knut Wicksell in the 19^{th} century, and Dennis Robertson in the 20^{th}, this has been thought to be a matter of banking policy. However, in practise it is the expenditure of firms that determines production, the turnover of credit in the economy and, hence, the liquidity of firms, households and government. In turn, that liquidity decides the ability of indebted units to service their debts. Banking policy is therefore endogenous to the business cycle, rather than determining that cycle.

Nevertheless, economists usually think of national income, or Gross Domestic Product (GDP) as something that is produced and, in that process of production, incomes are created. This is of course the foundation of the theory of value and distribution. But in a credit economy, national income can also be viewed as an adjustment of debt stocks. Debt stocks in turn can be divided into public or government debt, and private, that is non-government (household and firms') debt. If we exclude purely financial debt transactions (that is, the debts entered into in order to buy financial assets) the remaining debt stocks must overall be kept constant for national income to stay constant. Thus, a reduction in government debt, without an increase in private debt, would result in a reduction in national income. A reduction in government debt matched by a rise in private sector debt would hold national income stable, although there will obviously be a change in the structure of that income. Finally, a reduction in private sector debt, without any increase in government debt corresponds to Richard Koo's 'balance sheet recession'. However, it may be noted that hoarding of liquid assets by large corporations, in preference to investing profits in further production, a kind of liquidity preference alternative to repaying debt, has the same macroeconomic effect as using such profits to repay borrowing.[1]

2. The crisis in Europe cannot be overcome by either lowering real or nominal wages, or by devaluation of a particular country's currency. Lower wages induce lower prices in competitive markets, raising the real value of debt and prolonging debt deflation. In non-competitive markets, prices do not fall but demand shrinks because of the lower incomes, leading to reduced sales and difficulties in servicing financial commitments. Competitive markets therefore squeeze the ability of firms to service inherited debt commitments. Non-competitive markets squeeze the ability of households to service inherited debt commitments. Here it is worth noting that, in Europe, housing, energy and transport make up the bulk of household expenditure, and their rising costs, relative to wages, are a major factor in the present deflation.

3. The extent of economic integration in Europe, that is the high ratios of imports in the total national incomes of European countries, makes devaluation less effective (because of the rise in import prices). Here a key structural factor was introduced into the European economy by the policies since the 1990s of creating a single market for financial services. Following a series of cross-border mergers and acquisitions, there has emerged, with the tacit encouragement of the European Commission, a system of pan-European banks, such as Société Générale, Deutsche Bank, Unicredit, Santander, whose branches may be found in most of the countries of the European Union. The key policy issue with these banks is not because they may be 'too big to fail', but because of their large cross-border holdings of assets, and corresponding liabilities. This means that any break-up of the European Monetary Union smaller monetary unions, or a return to national currencies, that would fall in value against the currency of Germany and its remaining satellite economies, would result in widespread insolvency, or at the least balance sheet instability, among banks with cross-border exposures.

[1] Equity in this situation may be viewed as a type of debt on which payments are wholly discretionary. There are, in addition, endogenous processes whereby reductions in net debt by governments, firms, and households are to some extent off-set by the 'forced indebtedness' of governments (through, for example, the increase in welfare payments without corresponding tax revenue increases) or firms and households borrowing to cover income deficits. Further discussion of this may be found in the works of Kalecki and Steindl.

At the same time, the financial crisis since 2008 revealed that, under the Maastricht Treaty there is not any effective lender of last resort capable of supporting larger banks. This again is not an issue of ‘too big to fail’ but one of guaranteeing cross-border assets and liabilities. Most starkly, a German government guarantee of Deutsche Bank assets and liabilities in, say, Greece, would arouse serious controversy in Germany. Any rescue, as the Irish case shows, increases significantly government borrowing and turns limits on government borrowing into pious, but unreal aspirations that signal a government’s inability to control its debt. Yet the question of support for banks becomes more urgent as deflation destroys the liquidity of large sections of the private sector and the breaching of Maastricht limits on government debt stigmatises such debt and makes it difficult to sell.

4. A start towards stabilising the banking and financial markets through financial policy innovation was made by the European Central Bank with the initiative in November 2011 of lending long-funds to Euro-zone banks directly from the ECB, the Long-Term Refinancing Operations (LTRO). These operations were designed to make commercial banks holdings of long-term bonds, offered as collateral to the ECB for loans under the LTRO, more liquid. This had the desired effect of bringing down long-term bond yields. The measure was followed to steps towards setting up a Banking Union and a single bank regulator for the European Monetary Union, to relieve its governments of the financial embarrassment of providing lender of last resort facilities in the Union. These initiatives are helping to support the banks of the Euro area. But they cannot break the deflation that is causing the assets of those banks, in the form of their loans to governments and the private sector, to lose value.

5. These measures to support banks explain the paradox of peripheral countries applying to join, such as Iceland, and joining, such as Latvia, the European Monetary Union as it goes through its greatest crisis. Governments of countries with banks that are failing because of the deflation in the European economy, are naturally enthusiastic to be relieved of the need to indebt themselves in order to guarantee banks affected by deflation.

6. The way out of the deflation must include at least the following three elements. First of all, a planned policy of stabilising and increasing wages, to rehabilitate domestic consumer markets. Secondly, more active open market operations by the European Central Bank are necessary to preserve the liquidity of banking and financial markets. Thirdly more active

fiscal policy is essential as a temporary substitute for the fall in private sector investment. Since fiscal policy has been disabled by difficulties in the markets for debts issued by national governments, governments should introduce an annual tax on all financial assets in registered balance sheets above a certain minimum size. The revenue from this tax should be used by national debt management offices to buy in government debt and thereby resume control by the government of the yield curve for government paper. Such a tax, and buying in of government debt, would discourage the hoarding the liquid assets by companies, in preference to productive investment, and concentrate liquidity on fixed investment and on government debt. In the end, economies based on private sector investment must engineer such investment, or manage it effectively, in order to secure a sustained recovery.

Conclusion

These notes put forward a macroeconomic view of the European difficulties from a banking perspective. In that perspective, national income is the outcome of changes in debt stocks. However, in our complex credit economy, macroeconomic imbalances between income and expenditure work themselves out through debt structures creating new macroeconomic imbalances. The resulting business cycles are accommodated or reinforced by changes in debt stocks. The monetary and regulatory authorities may shift that accommodation between different financial institutions, or in and out of informal credit or shadow banking. But those authorities cannot regulate those business cycles by regulating credit. In any inflation-targeting regime, the business cycle controls monetary policy, and not the other way around.

*Jan Toporowski is Professor of Economics and Finance at the School of Oriental and African Studies, University of London. His most recent book is *Michał Kalecki An Intellectual Biography Volume 1 Rendezvous in Cambridge* (Palgrave Macmillan 2013).