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About winners and losers: the Euro Area example

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Introduction

In economic life, like in all walks of life, there are always winners and losers. The losers are the unemployed, often the young, the low-income earners, the individual households who lose their home due to repossession for non-payment of debt, the households who have no or a low savings level and the many who see their wages grow slower than inflation levels.

The losers in economic life, generally speaking, do not choose to be losers; they are willing to work but outside circumstances prevent them from (fully) participating in economic activities. To be a winner or loser in an economy is not just the result of some random events taking place; governments and central banks can create winners, but can equally create or become losers in the economic game themselves.

The collective U.S. banking system caused the 2006-2008 economic and financial crises. The U.S. banking system sold U.S. home mortgages to individuals in the U.S. and subsequently to investors in the U.S and in Europe in an irresponsible manner. The U.S government became as much a loser as all the Euro area countries.

The main aim in all type of economies is to turn losers into winners. The more successful governments and central banks are, the more winners there are and the higher the level of prosperity.

The key to help economies recover lies in a focus on using existing savings in a more effective manner. The losers group increases their losses when, for instance, house prices rise faster than average wages, especially for those not yet on the housing ladder. The same phenomenon occurs when share and bond prices appreciate faster than wages growth, again especially for those with low or no savings. Unemployment creates losers as well.

Savings and debts are two sides of the same coin. One may increase government debt to provide a fiscal stimulus; however the costs of such debt increase falls squarely on all individual households: they are the losers, may be not in the current period, but certainly in future times. Central banks may experiment with buying up government debt, corporate debt in one form or another or mortgage debt. Such debt replacement strategies lower effective interest rates and increase share prices. The losers are those with low or no savings and those with bank deposit savings. Each current economic strategy creates its own losers.

The Euro Area is an interesting example of how countries and individuals in these countries have suffered from the economic onslaught brought about by the financial crisis. For the Euro Area, the 18 European countries which share a common currency, but have no common fiscal structure, the search for such a “create winners” strategy may be all the more important so as not only to strengthen individual economies, but equally the currency which is used by all 18 countries.

1 The current state of affairs in the Euro Area

Consumer price inflation

The European Central Bank (ECB) targets inflation of just below 2 percent over the medium term, but the current annual rate has fallen to just 0.3 percent this September. This has raised concerns that some countries in the Euro Area could see deflation. In a quarterly Survey of Professional Forecasters it was suggested that this year's euro zone economic growth would be weaker than previously expected after the German economy shrank in the second quarter of 2014 and France stagnated. The ECB's third quarter SPF showed a drop in the inflation forecast for this year to 0.7 percent from 0.9 percent previously. For 2015 the forecast was cut from 1.3 percent to 1.2 percent.

The ECB indicated that the lowered inflation expectations were, among others, "linked with the general disinflationary environment and ongoing lagged impact of previous exchange rate and commodity price developments as well as a slightly softer real economic outlook".

Some countries, such as Greece, are experiencing deflation as they lower wages and costs to make their economies more competitive. Italy has shown a deflation pattern and Belgium, Spain and France experienced price falls.

Government 10-year bond yields and government bond debt to GDP level

10-year government bond yields for Euro Area countries have shown a highly unusual pattern over the last 15 to 20 years. Germany's average 10-year bond yield over the period 1980-2014 was 5.57 percent, with a high in September 1981 of 10.80 percent and a low of 0.88 percent in September 2014. In France its high was reached in 1985 at 11.9 percent and its low of 1.43 percent in August this year. Italy over the period 1991-2014 had an average yield of 6.39 percent over its 10-year government bonds, with a high of 15.29 percent in October 1992 and its lowest level of 2.64 percent in July this year. Spain's average government bond yield over the period 1991-2014 was 6.07 percent with its top in October 1992 at 14.03 percent and its lowest ever level of 2.59 percent in August 2014.

In all the main Euro area countries the costs of funding an increasing government debt level has come down to historically the lowest levels for at least 35 years. In 2007 Euro Area government debt to GDP level reached its lowest level of 66.20 percent out of the period 1995-2013. Its highest level was reached in 2013 with the level of 92.60 percent. Over the last seven years the volume of government debt went up dramatically but the price of debt -the 10-year government bond yield- went down to its lowest levels ever.

Unemployment

In September 2013 unemployment in the Euro Area reached its highest percentage at 12.0 percent of the labor force. The number of unemployed stood at 26.872 million in the same month. Youth unemployment levels were

extremely high at 3.548 million. In Greece it reached 57.3 percent of all youths, in Spain 56.5 percent and in Italy 41 percent.

Economic growth

Mario Draghi, head of the European Central Bank said the economic recovery of the Euro area remained: “weak, fragile and uneven”. Germany and Italy showed a negative -0.2 percent growth in the second quarter of 2014; France a 0 percent growth over the first half of 2014. The other Euro area countries showed a sharp slowdown in growth as compared to the same quarter 2013. In Germany new orders for the manufacturing industry fell by 3.2 percent in June 2014, with orders from the rest of the Eurozone collapsing by 10.4 percent. One senior economist concluded that Europe is nowhere close to recovery.

2 Links between winners and the losers

2.1 Financial links

The financial links between winners and losers are nearly always indirect. During the period 2006-2008 individual households in the Euro Area (EA) turned from winners into losers through no fault of their own. This was caused by the U.S. home mortgage crisis, which spread to Europe through the sale of U.S. mortgage backed securities to European investors. The subsequent financial losses hit European pension funds and banks. The reaction of central banks on both sides of the Atlantic was to lower benchmark interest rates to their lowest levels for a generation. EA government debt levels went up from 66.2 percent of GDP in 2007 to 92.6 percent in 2013. However the return for new savers went down very substantially. In Germany the 10-year government bond yield dropped from the long-term average of 5.57 percent to 0.88 percent in early September 2014. In Spain and Italy it dropped from the long-term average of slightly over 6 percent to 2.15 percent in the same month. Savers, both individually and through their collective savings vehicles as pension funds, saw a great reduction in their earnings over their savings while simultaneously seeing their collective income reduced through higher unemployment levels and a growth in pay levels below inflation.

EA governments also turned into losers as the lower income out of both work and savings and the reduction in the volume of demand for goods and services led to lower tax receipts. On the other hand government expenditure levels went up in the form of unemployment benefits and other social benefits.

The key question for the EA and for its currency the Euro, is how can large groups of losers be turned back to winners again. The results of the actions taken since 2008 can only be described as very poor. Extremely high youth unemployment rates and historically high over-all unemployment rates are still in place. Company loans are still shrinking at a rate of 2.3 percent. Factory gate prices are falling at a 1.1 percent rate. Eurozone retail sales fell in July 2014 and consumer confidence dropped to a six-month low in August this year. Negative

GDP growth rates or very low rates of growth are recorded in most EA countries. Deflationary pressures are openly discussed as a current scenario. Debt servicing under a deflationary scenario becomes much more problematic.

2.2 Savings and government debt levels

Are savings scarce? Since 2008, the volume of savings by individual households held in all different forms, like pensions, life insurance, mutual funds and individual savings and deposit accounts, do not appear to have prevented EA governments to increase their government debt levels by practically 40 percent as compared to GDP. Not only appeared such funding easy, it was also accompanied by the most extreme lowering of the 10-year government bond yield levels seen in decades. During the period from 2008 large companies started building up substantial cash reserves, adding to the savings surplus. The drop in factory gate prices in the EA provides no incentive to companies to borrow more for capital goods investments.

Nowadays institutions on behalf of individual households control a large share of total savings. For instance sovereign investors manage \$29.1 trillion of savings, which equals about 40% of annual global economic output. According to IPE¹ the total assets under management of the top 400 asset managers in the world are €42.7 trillion in 2014 or \$55 trillion. These are just two of the institutional groups managing financial resources in the world.

Nearly all governments, which, according to financial markets' opinion, run an acceptable economic policy, can easily fund their deficits. Such opinion is very fidgety and can dramatically change from one day to the next. However when a positive opinion is in place, very little restraint is shown by the market place to provide funding to governments. The restraint is generally not in the supply of funds, but should be in the long-term effects of unlimited government budget deficit funding. Ever since 2008, the yields over 10-year governments bonds have come down to the lowest levels for many, many years; this happened against the background of an increase in EA government's debts by some 40%. The debt volumes have gone up dramatically and the costs of debt have come down substantially. This market experience is the reverse of a normal price development in a demand-supply situation. What should not be forgotten is that government debt is identical to individual households' debt, as the latter will have to pay for servicing a government's debt.

2.3 Savings and the individual households' debt levels

Savings made by individual households are made via collective vehicles – sovereign funds and asset and pension fund management companies, for instance- but also individually: usually the largest share of individual savings is invested in their homes.

¹ <http://www.ipe.com/reports/top-400-asset-managers/>

Savings can add to economic growth, if used sensibly, but they can also slow down such growth. Take the U.S. experience since 2008. This experience showed that the outstanding level of mortgage debt decreased when at the same time the value of the housing stock increased. In 2008 the value of individual households' real estate was worth \$17.444 trillion². At the end of the first quarter 2014 the value had increased to \$20.165 trillion. Over the same period the level of outstanding mortgage debt dropped from \$10.579 trillion in 2008 to \$9.349 trillion as per end of 1st quarter 2014. Owners pumped an extra \$1.2 trillion of their incomes into savings through the process of reducing the collective home mortgage levels. The owners' equity as a percentage of real estate increased from the low level of 39.4 percent in 2008 to 53.6 percent by the end of 1st quarter 2014. The 39.4 percent was an extremely low percentage by U.S. historical standards. In 1986 it was 68.2 percent; by 1996 it had fallen to 55.7 percent, which is not far from the current level.

The process that took the U.S. from a conservative 68.2 percent average equity in their homes in 1986 to 39.4 percent in 2008 had all to do with bank lending and the mortgage backed securitization process. A rapid growth in the percentage of debt as compared to home equity drove the risks to economic growth to breaking point. Over the period 1996 to 2005 the net annual increase in the outstanding U.S. mortgage portfolio went up from \$218 billion in 1996 to \$1.099 trillion in 2005, a fivefold increase. The debt bubble also drove house prices to increase far faster than the CPI inflation levels. Average wages growth was much closer to the CPI changes, which meant that the risk profile for the whole U.S. economy was stretched far above its limits. In 2008 the U.S. economy went into a severe recession with millions of job losses.

The U.S. case shows that maintaining the owners' equity percentage in homes would have been a far safer economic objective rather than allowing the gearing of personal incomes to run totally out of hand. The Euro Area suffered from the lack of financial leadership by the U.S. The U.S. authorities condoned unrestricted increases in mortgage debt in the run-up to 2007. The developments in the collective mortgage debt to home equity –the owner's equity percentage- were not considered to have any material effect to what happened in the U.S. economy and beyond. The prevailing view was that it was not considered a government concern, but one of banks and individual households. The 2008 economic crisis, which followed the mortgage debt crisis, showed how wrong this view was and how many individual households, companies and the U.S. government itself suffered from the lack of action when it mattered. They all became losers.

The fall-out from the U.S. affected all European countries. The current difference is that the U.K. and the U.S. appear to be back on track with economic growth and employment creation, but that the EA still lags far behind.

2.4 The European Central Bank

² <http://www.federalreserve.gov/releases/z1/current/z1r-5.pdf>

The most recent actions of the ECB (early September 2014) were a cut in the base rate from an already extremely low 0.15 percent to 0.05 percent. Secondly the deposit rate for banks depositing funds with the ECB was cut from -0.1 percent to -0.2 percent. Thirdly the ECB plans to buy a “broad portfolio” of asset backed securities, including mortgage bonds. The ECB expects that its balance sheet will be extended by about €1 trillion in a year from now. Also its four year lending scheme for banks against collateral from the banks is also put into place.

What all these programs have in common is the belief that low interest rates and liquidity provided to the banks and the other players in the financial markets will stimulate lending. However recent evidence shows that the ECB’s balance sheet has been shrinking as banks have reduced their long term loans down to €2 trillion from €3 trillion two years ago.

The real question for the ECB and for the politicians in the Euro area is: Does a stimulus work better through adding debt to companies, individual households or governments? Does quantitative easing i.e. printing Euros to buy up outstanding government debt titles or asset backed securities really help individual households to be able to spend more? Should the ECB accept exposure on loans granted to companies or individuals through the asset-backed back door? In doing so, is the ECB not being turned into a commercial bank with all the risks that commercial banks have to run on their client base? Is the role of supervisor and the supervised not becoming mixed up? Unemployment matters, inflation or the lack thereof matters and the value of the Euro matters. However an appropriate question is: Could there be other methods to help individual households to spend more without personally incurring a higher level of personal debt?

Falling factory prices and reduced demand levels may tilt the answer towards the latter method: an incomes push for individual households, without however creating more deficit funding for governments and simultaneously not increasing individual households debt levels.

3 The economic growth incentive method (EGIM)

3.1 Introduction to EGIM

A recent article of the Financial Times³ was devoted to the subject of “pay pressure”. It concluded that rich countries have lost the knack of improving middle class living standards. The OECD indicated that almost all advanced economies have seen labor’s share of gross domestic product fall over the past 20 years. In the FT article a number of top economists were asked for their ideas to jump-start wage growth.

The EGIM method reflects such an attempt.

³ Financial Times 19 September 2014: Pay Pressure

For the economic growth incentive method to work well it needs to fulfill seven conditions:

- EGIM should not affect the volume of government debt outstanding in an EA country;
- EGIM should not affect the volume of each individual household debt outstanding in a particular EA country;
- EGIM should not be a transfer of cash from one EA country to another;
- EGIM should not be based on increasing the costs of labor in any EA country;
- EGIM should also not be based on a transfer of income from the rich to the poor, either within an EA country or cross-borders;
- EGIM does not require ultra-low interest rates;
- EGIM should be a temporary measure only.

These conditions do not imply that each individual EA government could not decide to increase its own debt level, raise minimum wages, transfer money from the rich to the poor or transfer money across borders, but it does imply that it is possible to provide incentives for economic growth without doing all of these things. These conditions are also not dependent on the ECB maintaining ultra-cheap cash.

How is this all possible and how can the objective of economic growth be achieved?

The answer can be found in a better use of existing savings.

3.2 A slightly different role for the European Central Bank

The current situation is that official Euro interest rates are at rock bottom and that banks have to pay the ECB for the privilege of parking cash surpluses with the ECB.

The ECB, unlike the Fed and the Bank of England for their respective countries, has not (yet?) decided to go for buying up EA government debt titles. In the U.S. and the U.K. such quantitative easing action has turned their respective central banks into the provider of funds to their governments. In doing so, QE replaced private sector savers and reduced the costs of funds dramatically for their respective government. Another side effect was that QE simultaneously reduced the rewards for holding government debt titles as well as on any type of cash holdings by the private sector; the private sector households were the big losers in this game. Over the period 2008-2014 the supply of government debt titles increased dramatically in the U.S. and the U.K. and the price paid for each title dropped substantially. The cause of the price drop was Central Bank intervention, not a market driven supply and demand for government bonds. Had the Fed and the Bank of England attracted savings from the private markets to fund such government bond purchases, the income effect on savers would

have been neutral; however both Central banks just created (= printed) money to undertake QE.

The justification used by both Central banks was that the freed up savings would spur the private sector into investments by the corporate sector and more borrowings by the individual households. Neither happened as major companies decided not to expand production facilities. Reason was that, generally speaking, demand levels for their goods and services were not growing; therefore large companies started hoarding cash. Individual households also started saving more from their reduced collective income from work activities. In the U.S. they collectively reduced their outstanding home mortgage debt by \$1.2 trillion over the period 2008 to end of first quarter 2014.

The U.S. experience is very relevant to the European Area countries. In the U.S. the savings allocated to repaying mortgage debt were savings made out of incomes. The total savings stock does not diminish as the repaid amounts were returned to the original lenders, but disposable incomes were reduced. Mortgage debt and consumer debt can add to an increase in the level of disposable incomes, but debt servicing can also reduce such incomes. In other words changes in individual household debt levels can help economies grow, but at different times such changes can slow down economic growth.

QE exercises did not induce individual households to borrow more as the U.S. experience showed. QE does lower the borrowing costs for governments over their debt. However the losers are the individual households as their income over such debt is severely curtailed.

The current strategy of the ECB is quite similar to the objectives of QE: to induce more borrowings by both the company sectors and the individual households in the EA countries. As Reuters put it: to flood the market with ultra-cheap cash. The problem is that the company sector and the individual households in the EA countries are trying to repair and restore their own balance sheets, before wanting to consider to borrow more to expand their economies. The EA is still three to four years behind the current economic situation of the U.S.

What the ECB has not considered and neither did the Fed or the Bank of England at the time, is to help redirect savings to income levels, rather than stimulate savings to go into more borrowings.

Savings are not scarce in the world; income generation is. If the ECB would consider taking deposits, i.e. raise loans from the savings markets; it would act as any commercial bank. However the ECB's purpose of taking up such loans would be totally different from any commercial bank, namely a temporary transfer of savings to help incomes grow. The alternative, only available to a central bank, is to put on the money printing press, a process that harms all savers. The latter action is contrary to one of the aims of a central bank, which is to protect the value of a currency.

In the past many economists have promoted the idea that using additional savings is the role of a government rather than of a Central bank. A fiscal stimulus package increases the disposable incomes levels of the private sector. Increased infrastructure spending is another favored method to do so. The main draw back is that both such actions cannot easily be reversed when good economic times return. Secondly increasing government deficits at times when such deficits are already under severe strain leaves the population with more rather than less debt to be repaid in future years. The savings allocated to government deficit funding are identical to consumer debt funding: they can both increase but also decrease economic growth. How the EGIM method could work is set out in the next section.

3.3 The EGIM method explained

As an example take the case of Spain: the proceeds of such ECB bonds are transferred from the ECB to the Bank of Spain, Spain's central bank. The concept is that Spain's central bank will organize a distribution of the proceeds over all the 17.4 million Spanish households. The principle of an equal amount of cash for each household could be applied. This will help the lower income level households more than the more affluent ones. It makes economic sense.

In Spain the average net household income level was €23,123 in 2012 according to INE, Spain's national statistical office⁴. This was practically 10% less than the 2005 level. To kick start the economy a cash injection of 4% in year one over the average net household income, followed by a lower percentage a year later, would probably be the best approach. In year one, a fixed amount of about €1000 per household would best be paid to all households, which helps the lowest 20% of the households the most and the top 20% the least. Total costs: €17.4 billion in year 1. The best approach would be to allow this amount to be paid tax-free. The €17 billion is a fraction of Spain's government deficit of €73 billion over 2013, but such deficit has had no lasting impact on unemployment levels as it did not deal and could not deal with the substantial deterioration in individual households' average income developments. The deficit was used to keep funding government programs, which had priority as decided by the Spanish parliament. The EGIM method does not finance government programs; therefore it can make a difference.

The pay back could be arranged out of general tax receipts over a ten-year period including two-year grace and an eight-year reimbursement. Of course, the expectation is that with the multiplier effects of the cash injection, tax revenues will increase, without having to change tax rates. For Spain it does not count as government debt as the Spanish government has not incurred a government deficit to fund this transaction. It is in effect a collective individual households' debt to be repaid out of the tax income generated out of the increased economic activities of the working population and the company sector.

⁴ <http://globaleconomicanalysis.blogspot.co.uk/2013/11/spain-household-income-drops-10-to-2005.html>

The ECB could issue 10-year index-linked bonds. Such bonds could be linked to the average inflation rate in the 18 Euro area countries. Such bonds have two advantages over fixed rate bonds. Firstly the ECB makes use of a combined inflation rate from the 18 countries sharing the Euro as their currency. Secondly the ECB reduces the risks to all type of investors' -institutional or private-. These investors see the values of the bonds fluctuate in case the Euro interest rate, based on the average inflation rate, has to be increased. Especially institutional investors will benefit from index-linked bonds, as their mark-to-market accounting method will avoid showing substantial losses when interest rates rise. For both institutional and private investors the positive yield over inflation will bring in a cash flow, which is more likely to be used for consumption in the current period rather than being kept as a financial saving.

Spain was used as an example of the EGIM method. EGIM's philosophy could be applied to any Euro Area country that has high unemployment levels. The indication of success is when all those who could work, would have found work. The losers would have been turned into winners.

As a method it will bring home the message to all Euro area citizens, that the ECB is not only in existence to maintain the value of the Euro, but also to help EA economies and especially employment levels to grow. The Euro as a currency will be strengthened, but not unimportantly, Euro area citizens will experience a direct benefit from being a citizen in one of the Euro area countries.

3.4 Will the conditions be fulfilled?

- Government debt levels

The EGIM method does not affect a government debt level of any EA country. It is not the government that provides the fiscal stimulus by reducing its tax revenue levels. It is not the government that starts up major infrastructure projects and thereby increases its deficit funding level. Any EA government's fiscal priorities are not affected. The EGIM method is a self-financing scheme, to be reimbursed directly out of increased revenues generated out of higher employment and income levels from the private sector, without having to change tax rates.

- Individual household debt levels

The EGIM method does not affect individual household debt levels, as each payment is not based on an individual but rather on a collective repayment schedule. The increased consumer spending will cause companies to increase production and create more jobs. The reimbursement of the funds provided is based on higher levels of tax revenues from individuals and companies, without having to resort to increasing tax rates. The Spanish and other EA governments will also be winners, as their tax expenditure will reduce due to lower unemployment and other social benefits.

- The transfer of funds between EA countries

The EGIM method does not depend on a government-to-government transfer of funds. International savings will be used and channeled via the ECB and national central banks to all individual households. There is neither an implicit or explicit government guarantee from any EA country.

-The impact on the costs of labor

The EGIM method does not increase the wage levels in any EA country. It does not stop companies to raise wages, but the method does not require any company to make changes to their wages levels.

-Transfer of incomes from the rich to the poor

The EGIM method will benefit the poor proportionally more than the rich as an equal amount of cash will be transferred to each individual household. Percentage wise the poor will be better off. However the rich are not asked to pay more taxes than they currently are already doing. The same applies for the rich in any of the Euro Area countries.

-Ultra-low interest rates

The EGIM method does not require interest rates to run at ultra-low levels. The method reflects a cash transfer to individual households, without any incentive for individual households to borrow more in their own right. The method is a collective rather than an individual households borrowing. The collective method is less sensitive to the level of interest rates prevailing.

-The EGIM method should be a temporary measure

To change and implement revised tax structures in any country takes a considerable time. Once, as an example, income tax rates are lowered, few politicians will find it opportune to raise them again when an economy runs at full employment. To start up infrastructure works takes even longer. Neither of these methods has the flexibility to turn the tap on and off as and when required. The EGIM method has such flexibility to vary the medicine doses according to the different levels of unemployment. It really is a temporary measure over which the ECB and the central banks can exercise control. It will work fast and the results will show up over a very short period of time. It will be the most effective short-term method of employment and income creation.

Can it be done? The answer is with the ECB and its governing structure.

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