DON'T LET THE REAL ECONOMY DOWN!

I. Jobs and the real economy are in major trouble…

The past few weeks have seen impressive action from governments on the financial side of the economy. To avoid an immediate meltdown of the banking system, European governments have drawn up coordinated plans to inject hundreds of billions of euros in the banking system (see Table 1). This has been followed by a highly necessary and overdue cut in interest rates from the European Central Bank.

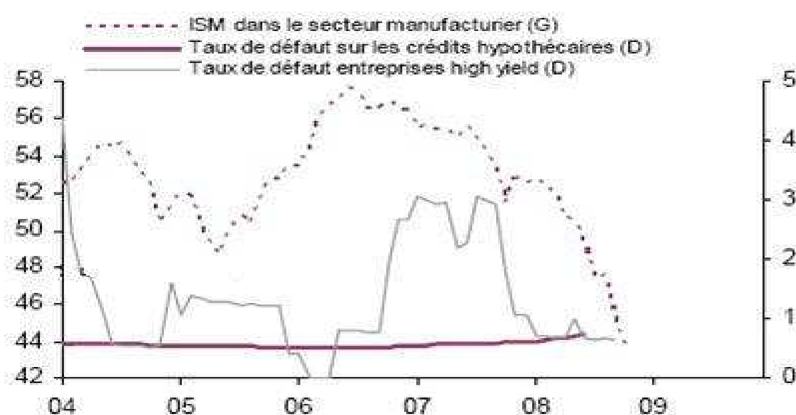
Table 1: Bank bail-out programmes announced in October 2008

Pays	Prises de participations dans le capital des banques	Garanties de prêts, de financements
Etats-Unis (Mds $)	250	450
Royaume-Uni (Mds £)	37	Garantie interbancaire
France	40	380
Allemagne	80	320
Espagne	0	50
Italie	20	0
Suisse	0	60
Pays-Bas	20	180

Source: Natixix

However, the news emerging from the real side of the economy is alarming. Falling gross domestic product (GDP) in the second quarter is now followed by alarming developments such as the temporary closure of major car plants throughout Europe and the collapse of a number of jobs in the temporary agency work sector. Moreover, leading business cycle indicators point to a severe downturn. The Purchasing Manager Index for the euro area (see Figure 1) has now reached a level pointing to a strong contraction of production.

Figure 1: Purchasing Manager Index for euro area, 2004–2009



Sources: Datastream, Natixis

Given these developments and the seriousness of the credit squeeze, the European Trade Union Confederation (ETUC) expects growth in the euro area economy to turn negative in 2009, as well as inflation to fall substantially and dive under 2% while continuing to decelerate further over the next year.

The bad state in which the real economy finds itself should not come as a complete surprise. Besides the additional credit squeeze coming from the most recent turmoil in financial markets, the 2008 slowdown has also been shaped by the actions and non-actions of economic policymakers over the past quarters.

1. The series of interest rate hikes implemented since the end of 2005 has succeeded in pricking the housing and construction boom in countries like Ireland and Spain, thereby removing one key element of good growth performance in the euro area.

2. Not only have interest rates been left unchanged at high levels for the past year, turmoil in financial markets has pushed three-month bank interest rates even higher from mid 2007 onwards. In this way, the impact of monetary policy tightening has been intensified further.

3. Financial market turmoil did not only push up interest rates, it has also led to banks tightening credit conditions for new lending. This was already apparent from European Central Bank (ECB) surveys as early as the beginning of 2008. It is also common knowledge that the consequences of such credit tightening tends to show up in the real economy in the form of bankruptcies some six to nine months later. Nevertheless, economic policymakers decided not to look at this 'early warning' signal and did not act on time.

II. … and plans to rescue banks have suffered because of this

Europe is paying the price for this neglect of the threats to the real economy. When the multi-billion European plan to recapitalise the banking system was pieced together at the beginning of October 2008, its basic aim was to break the vicious circle of:

- loss of banking capital because of write downs on 'toxic' assets;
- 'firesale' asset sales to respect Basle II solvency ratios;
- further collapse of asset prices resulting in more write downs and more capital losses for banks, hence new firesales of assets.

Governments, by injecting massive amounts of new capital into banks, were trying to stop this downward spiral. This, however, has not been entirely successful. Whereas the pace of the downward spiral has certainly been slowed down, the spiral itself has not been stopped. Equity markets and other asset markets have continued to destroy value ever since. The reason for this situation is that financial markets, after a first reaction of relief that governments had intervened in the sector, started to note that the banking rescue plan failed to save the real economy as well and that troubles in the real economy would spill back over into the financial sector, thereby adding to existing banking problems. As a result, the downward spiral started to operate again. Expectations about an economic depression depressed equity and asset prices,

thereby destroying part of the extra bank capital that was promised by governments. Due to their failure to stabilise the real economy, governments are now in danger of loosing the race between injecting new capital in banks and massive write downs in banking asset value.

III. Four lessons from Japan : How to avoid getting trapped into deflation

At the beginning of the 1990s, Japan was facing a similar situation. An asset price bubble had developed and the Japanese private sector had massively built up debt to finance this bubble. After the Japanese central bank tightened monetary policy and had pricked the bubble, households were left with high debts and banks were facing bad loans in their portfolios.

In the process of driving down debt back to reasonable levels, Japan made several policy mistakes. Its economy rapidly fell into deflation and got trapped in a situation of continuing low growth for more than a decade.

Here are a number of lessons to learn for European policymakers from the Japanese debt deflation process.

- **Make sure monetary policy wins the race against deflation.** To drive down debt, the private sector starts to save more and to invest less. The slowdown in domestic demand drags down overall growth and creates overcapacity. Disinflation follows. If left uncontrolled and if interest rates are not cut in time to stabilise the economy and stop this trend, disinflation eventually turns into deflation. From that moment, the zero bound on nominal interest rates bites. Real interest rates start increasing again and monetary policy loses much, if not all of its power to stimulate the economy.

Japan indeed got stuck in such a liquidity trap (see Figure 2). From 1992 onwards, the Japanese central bank did cut interest rates from what had been extremely high levels – 8% interest rate with inflation running at less than 4%. Meanwhile, however, inflation started falling as well. Two years later, nominal interest rates were still at 2%, while inflation had turned to zero and then negative. By reducing interest rates too slowly, Japanese monetary policy had missed out on the opportunity to stabilise the disinflation process in time. Against this background, negative real interest rates were no longer possible and the Japanese economy paid the price for this outcome in the form of continuing slow growth.

Figure 2: Interest rates and inflation in Japan, 1988–2008

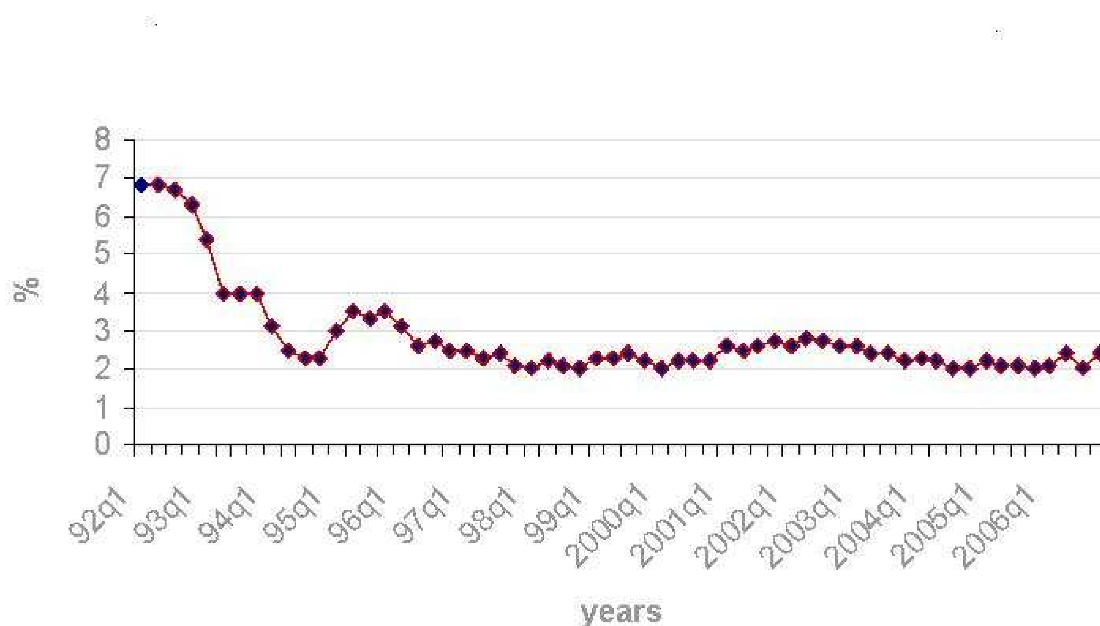
Sources: Datastream, Natixis

Lesson No. 1:
The lesson to learn is to avoid inflation reaching zero before nominal interest rates can do so. With the ongoing credit crunch triggering a standstill in the real economy, a strong disinflationary process can be expected. European central banks therefore need to engage in the race against disinflation and win this race by deciding deep and fast cuts in interest rates.

- **Downward wage flexibility deepens and prolongs the deflationary trap**. Depressed economic activity in itself weakens the bargaining position of workers and trade unions. In Japan, however, this weakening of workers' bargaining position was exacerbated by the widespread existence of bonus systems at company level topping up regular or conventional wages. Confronted with lacklustre demand for their products and services, Japanese companies started to cut on workers' bonuses. As a consequence, deflation got prolonged because both domestic demand and cost-push inflation were absent.

Lesson No. 2:
Today, many European economies are characterised by a downward wage rigidity from the moment at which wage growth reaches 2% (see Figure 3). This is actually a good thing: it provides a downward floor to the process of disinflation and thus contributes to maintaining price stability. European policymakers would therefore do well not to attack and dismantle those wage formation institutions delivering this downward rigidity in the form of minimum wages, sectoral collective agreements, legal extension of collective bargaining agreements and limitations at company-level opening clauses. If European policymakers decide otherwise and try to compensate for the lack of competitive devaluations of national currencies by engaging in competitive cuts of nominal wage levels, deflation processes would be made stronger.

Figure 3: Collectively bargained wages in euro area, 1992–2006



- **Some structural reforms make matters worse.** Japan also responded to the continuing slowdown by degrading its tradition of permanent and highly secure jobs. New entrants in the labour market, mainly women, were forced to accept so-called part-time jobs. This type of jobs, however, needs to be understood in the Japanese context: in Japan, a part-time job means a full-time working schedule paid at a part-time rate.

This increase in precarious work also undermined the macroeconomic transmission channels. Any initial positive demand shock to the economy turned out to be weak and feeble since the benefits of the demand shock immediately went into profits and not into wages. Because of workers in precarious employment relationships having no bargaining power whatsoever, the multiplying effect of more jobs creating more purchasing power for workers and their households was no longer functioning.

Lesson No. 3:
The Japanese experience regarding precarious work also holds an important lesson for Europe. Indeed, in Europe, the use of precarious work is spreading in many different ways: jobs paying poverty wages, series of fixed-term contracts, agency workers paid unequal wages for equal work, involuntary part-time employment and fake self-employed people. Moreover, ongoing reforms – such as a backward revision of the Working Time Directive and misguided flexicurity reforms using the six weeks 'grace' period in the draft Temporary Agency Work Directive to organise a 'revolving door effect' – may be abused to accelerate precarious work practice in Europe. If this were to happen, the depression would be prolonged and the process of disinflation/ deflation would be prolonged.

- **Avoid pro-cylical fiscal policy tightening and allow the public sector to compensate for private sector de leveraging.** An economy going through a process of

driving down private sector debt needs to compensate this by accepting a certain increase in public debt. If it does not accept such compensation, economic activity will suffer substantially. In the absence of public investments supporting aggregate demand, private sector efforts to increase savings and cut investments will undermine overall growth. In turn, depressed growth and rising unemployment will push deficits upwards. Fiscal policy turns pro-cyclical if it tries to cut these deficits, thereby prolonging and deepening the slowdown. Japan again provides a telling illustration such a process. To cut the deficit and to keep public debt within limits, Japan decided to hike TAV rates in 1998. The results were catastrophic: the economic recovery was lost, economic growth decelerated sharply again and the Asian financial crisis was triggered.

Lesson No. 4:
In Europe, the Stability Pact lays the foundations for another potentially vicious circle. Depression pushes deficits up, fiscal policy reacts and more depression follows. Therefore, utmost care must be made when applying the Stability Pact. Certainly, in the present situation in which governments have rightly saved the banking system from collapsing by injecting massive amounts of capital, there is a high risk for policymakers to resort to pro-cyclical fiscal tightening. Instead, the Stability Pact needs to be applied with a high dose of flexibility to avoid such fiscal tightening.

IV. A new policy mix to save the real economy

The real economy finds itself in so much trouble and the situation has become so urgent that monetary policy can no longer ‘do the job’ all on its own. In normal times, monetary policy operates with substantial time lags, running up to one to two years. This means that the ECB interest rate cuts implemented now come too late. The main stimulus to the real economy will only come after growth and economic activity have already been depressed and confidence has been destroyed. Moreover, these are not ‘normal’ times. Financial markets are not operating as usual but are seriously distressed. Interbank lending rates are high above official interest rates, banks distrust each other and are reluctant to lend to each other. Liquidity is not transformed any longer into credits for investment but is put into safe-haven investment categories such as government bonds or is even returning back to the central bank in the form of central bank deposits.

In these circumstances, there is no other choice than to be pragmatic and call in the help of fiscal policy. Applying the traditional European policy mix of restrictive or even simply neutral fiscal policy being balanced by expansionary monetary policy will not work at this point in time. What the economy needs right now is another policy mix in which both fiscal and monetary policy turn expansionary.

Such a new policy mix offers several advantages.

- Fiscal policy, in contrast to monetary policy, has a direct impact on demand and the real economy. If decided timely, the 2009 recession can be headed off.

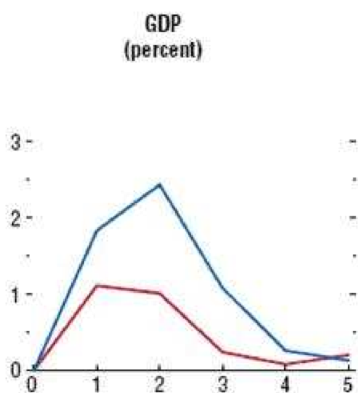
- Fiscal policy, in contrast to ‘one size fits all’ interest rate decisions, can be targeted. Priority can and should be given to bringing forward as well as expanding budgets for long-term investments.

- Doing so will not only help to get the economy through a period of what otherwise would have been seriously depressed activity, it will also strengthen the long-term growth potential of the economy. There is an opportunity here to combine the battle against the financial crisis with the agenda of investing in new industries, rational and sustainable energies, European networks and social housing.

- If fiscal policy is operated and/or coordinated at a European level, there’s a multiplying effect. If one member states acts alone, part of the stimulus disappears into imports from other member states. However, if all member states act on the same moment and in the same direction, one country’s imports will be another member states’ exports. As a result, the impact of the stimulus package on demand and growth will double.

- Moreover, a recent study from the International Monetary Fund, the IMF World Economic Outlook October 2008, shows that if a fiscal policy stimulus is accompanied by an expansionary monetary policy, the normal fiscal multipliers double or even triple (see Figure 4, in the case of monetary accommodation, namely government investment). One reason for such an outcome is that low interest rates make it affordable for the public balance sheet to finance such a stimulus package, so that concerns over the sustainability of public debt are ruled out.

Figure 4: Fiscal expansion effect in a large economy



Impulse responses to 1 percent increase in deficit in year 1 and 0.5 percent increase in deficit in year 2.

With monetary accommodation — Without monetary accommodation

Notes: Deviation from baseline; years on x-axis; shock occurs in year 0

All of this implies that Europe has the possibility of moving beyond the traditional trade off of either supporting and stabilising the real economy or giving priority to sound public finances. If the fiscal policy stimulus programme is well targeted at investment categories that have the greatest impact on demand, and if fiscal policy is coordinated or run at European level, the impact of such a programme on the real economy may be significant to the extent that

feedback effects from increased government revenue actually imply an improvement in government finance after a short period of time.

V. European leadership for European Investment Spending

How can Europe operate such a new and investment-friendly policy mix?

The starting point is to identify the fact that the financial turmoil and the high aversion for risk have created a serious inadequacy in today's global financial system. On the one hand, banks and businesses are in urgent need of new equity capital. On the other hand, global liquidity and savings are invested in short-term assets carrying no or little risk. Financial investors are mainly buying government bonds or moving into liquid bank deposits or even into central bank deposits. If left uncontrolled, this situation will continue to restrain credit growth, investments and overall economic growth.

This deadlock situation can be overcome by creating a EU-level Investment Fund of which the aim is to invest in renewable energies, energy savings, innovation and European infrastructure networks. 'Bubble' or speculative investment can then be replaced by 'green investment', functioning as a new and sustainable driver for European demand growth.

Such a European Investment Fund, operated for example by the European Investment Bank (EIB), would issue AAA rated bonds which are backed up by public sector guarantees. It would thereby correct the excess demand for non-risk asset investments in today's global financial markets and provide cheap finance for those investments the European economy desperately needs, both for short-term (overcoming the recession) as well as long-term purposes (transforming the structure of our economy into a more sustainable one).

Finally, it needs to be underlined that this proposal of a European approach to the crisis offers actors in Europe, such as the European Commission, a much needed opportunity to show leadership by organising economic cooperation across Europe instead of simply staying on the sidelines and letting Member States compete against each other.

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