Euro Bank and Federal Reserve steps: a difference between a recession and slow growth

It has taken far more time than needed to start a more expansive monetary policy in the euro area. It is a good first step the one recently taken by newly appointed Euro Bank President Draghi, but that will not avoid a Euro recession, for it takes time for money to have a relevant impact in economic activity. If these measures had been taken before, recession might have been avoided, as it will be the case in the US, a country facing otherwise similar conditions.

Both the US and Euro area are moving with expected inflationary rates around 2.5% and falling in the range of 2%. Both the US and Euro area have been battling with excessive government spending far beyond sustainable levels compatible with a dynamic private sector. But while solving fiscal imbalances and economic incentives takes time under a political process and even more time to see their results, monetary policy can at least make more probable that a natural growth rate in activity takes place, irrespective of what that natural rate is. Under a restrictive policy that does not allow monetary aggregates to sustain consistent growth beyond expected inflation and real growth, the adjustment basically falls on less activity, given price inflexibilities on the downside.

During this year, the Federal Reserve has managed to allow M1, the most meaningful and liquid monetary aggregate, to increase its growth rate to 20% in September with respect to September one year ago. In 2010 it grew around 8%. On the other side, the Euro Bank has been working with an M1 growing at 2% this last September and a little over 4% in 2010. In other words, M1 has been falling in real terms in the euro area, which is a perfect recipe, when consistently applied, for a recession. Do the US figures warrant future inflation? Not necessarily, if this extra liquidity is taken out as the economic activity reignites its growth, not before and neither after.

How about the fiscal noise, particularly in Europe? It does not help, for certain, but so it happens with the stress created by democrats in the US pushing beyond reasonable federal expenditure limits and republicans quartering on the tax side. In the euro case, it defies reason when looking at its fiscal deficit figures for the last decade: as a whole, they average a deficit of less than 2% of GDP until 2008, jumping to a little over 6% of GDP in 2009 and 2010. And these needed government funds have been essentially borrowed from their own domestic private sector: current account deficits have been negligible for the last 10 years, and even some years have shown surplus, lending money outside the Euro area. The problem has been government size, not financing. Greek tragedy? Greece represents less than 2.5% of Euro area GDP, the equivalent weight Cuba and Ecuador might jointly have in Latin America and Caribbean aggregate GDP. In other words, a situation completely manageable, unless European partners are not really partners in the sense of individual responsibility and long term mutual insurance, and growth stalls, not necessarily because of government imbalances but due to too stringent monetary policies. Sometimes it is more of an attitude problem: neglect does not work – Greece as a vivid example -; resolute willingness to correct does - as it could be the case of Italy and Spain-.

Once again, capital markets have been shown not to be trusted. It happened in 2008 and it has happened again. Its overshooting power destroys wealth and can turn manageable situations into unmanageable ones. For one moment, let us assume world GDP grows 2% next year, or half its recent rates. It would not be a tragedy, it would even involve some prices to be corrected, particularly commodities, but that would be all. No drama, and viewed from a very long term perspective, when world growth rates were chronically null, for ⅞ of the last 2.000 years, a great achievement.

Monetary policies on expansionary trends, fiscal policies to be structurally corrected, competitive markets: a half full glass perspective. However, capital markets might remain the pending problem. How do we deal with them, making their resource allocation more efficient and also responsible for overshooting results? Decreasing their leverage power via raising their equity standards would clearly be one way. The other complementary way, forcing governments to be equally capitalized, considering all its liabilities, particularly pension ones, would help a lot, for both overleveraged systems have taken the world beyond acceptable risk conditions.

Other Trojan horses in the horizon? Obama´s divisive and sometimes disoriented reelection might be one, emerging countries not learning from these developed countries missteps might be other ones.

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November 3rd, 2011