TAC
Applied Economic & Financial Research

THE BANKER'S COMMENT - JEAN-PIERRE PATAT

A former central banker looks at the news

April 2014, TAC Newsletter - www.tac-financial.com

Figure of the month: 4.95%, the 10-year bond rate fixed by Greece (5.25% was anticipated).

Deflation: the indestructible old chestnut.

We need to return to a subject for which the alarm bell has rung yet again, with the ECB standing in the accused box, since its "CEO" – according to an analyst in a respected newspaper – judges that "it is urgent to do nothing".

Perhaps, though, this is because there is not much to be done. Firstly, and contrary to what is said and repeated, nowhere does the ECB's mandate prescribe pressure on the accelerator when inflation is well below 2%, but rather it should consider its mission accomplished when price increases have fallen to a level below and close to 2%. Secondly, "to create inflation" is difficult, quite impossible even, when productive capacities are substantially under-used. Furthermore, CPI increases for the last two months are 0.1% and 0.1% in the Eurozone, where the central bank is dumb (as is well known), while in countries where the central banks are enlightened and (according to the well-loved but inexact expression of our analysts) churns bank notes out of the press, price increases are 0.2% and 0.1% in the US, 0.2% and 0% in the UK and 0.1% and ... -0.1% in Japan.

Also, any perception of an inflation level is skewed by the sole use of movement over 12 months. This is the worst possible indicator in terms of short-term cyclical diagnostic, since it incorporates data for the latest month and those of one year before without our being able at a glance to separate one lot from the other. If we annualise price increases for the last two months in France we arrive at 1.2%, i.e. twice the figure over 12 months.

In a previous chronicle we questioned the risk that consumers' purchases could be delayed by price decreases, arguing that were it so we would have had a great deal of trouble selling computers, digital cameras, smartphones or tablets and the like – items for which have seen spectacular "deflation" price-wise.

There remains the problem of debt that is lightened by inflation. It was thought that reduction of the budget deficit was the best way to reduce debt.

Finally, we persist in believing that deflation is not just about price reduction; rather it is a cumulative phenomenon and indeed disastrous, where self-reinforcing effects come into play with generalized declines in incomes, contraction in money supply and a lowering of prices, to cause economic stagnation.

Greece: are markets getting carried away?

Greece is back in the markets with a 20 billion sovereign bond issue at a most advantageous rate. Sceptics believe that Greece is benefitting from the flight of capital from emerging countries and the markets' certainty that the ECB will buy back sovereign debts.

If there is a flight from the emerging economies, it should be noted that it benefits the so-called "peripheral" countries more than the others, because bond spreads within the euro zone continue to shrink. As for the awaited action by the ECB, we know that the markets love fairy tales. We might also admit that Greece benefits from having resisted calls for what is discretely called debt restructuring – that is to say in a more direct manner, partial bankruptcy. Investors henceforth consider Greece as a solvent country (not the case for Argentina which is paying a high price for a payment default hailed enthusiastically by those for whom any lender is a Shylock, sucking the people's blood). Let's hope that markets do not make the same mistake as in 1999, when they considered that all debts from Eurozone States were the same, which is not the case – especially for reasons of liquidity and unstable interest rates linked to fiscal risks.

Concentrated attack on the strong euro.

The French are joyous. After the Prime Minister deplored the fact that the euro had gained 10% against the dollar over one year (in fact 4%), the ministers joined in and the governor of the Bank of France had his say on the topic. And then Mario Draghi brought up the subject himself, in most careful terms, provoking the enthusiasm of a daily newspaper which once had considerable competence in matters economic. Perfect. But wait for the rest. It is worth looking at statistics built up since 1990 on the competitiveness of the French manufacturing sector in terms of unit labor costs. These figures show first of all that our price competitiveness today is not as bad as all that. Next, that the exchange rate influence is secondary. Competitiveness improved spectacularly between 1994 and 1998, during a period of "competitive disinflation", the so-called "strong franc" policy. It started to decline when the euro was at its lowest versus the dollar in 2000. Thenceforth, it is hard to calculate the influence of exchange rates in the indices' variations. Is that surprising? A weak currency is a drug which prevents the attack on the true issues in competitiveness for a modern economy, apart from "specialising" in basic products and raw materials. It is no coincidence that the countries in the euro zone which have used and abused devaluation in the past are precisely those that have problems of competitiveness today.

Name of the month: Renzi.

The new President of the Italian cabinet provokes dreams, and we see a temptation to copy him. Not in everything, though, since where Renzi sets out in the near future to reduce the size of the Senate by 40% and to suppress the regions, here in France we are considering a territorial reform that may come about in ... 2021. No, it is increasing consumption via tax reductions that is exciting the French Keynesian masses. Except that, with a budget deficit of 2.4% of GDP, Italy has a margin that we do not enjoy with our 4.5% deficit, and our neighbour's external trade is in surplus while ours has long been in strong deficit. Any momentum for consumption would dig deeper into the deficit than it would stimulate activity. A policy that has in the past proved its absurdity under governments of all colours.

Banking regulation in the United States: The partisans of leave-well-alone are back.

The Volker ruling that seeks to introduce a structure for banks separating out market activities on their own account is raising criticisms in the USA because of supposed risks of reductions in markets' liquidity that could be brought about. At the head of the criticism of all new regulations is Alan Greenspan, ex-heart throb of the markets, who has gone back to hedge fund management; he describes the new regulations as punitive (vindictive) and not curative. It has to be said that one of the main points of the new rules lies in the strong restrictions applied to relationships between banks and hedge funds.

Each month, Jean-Pierre Patat, Honorary Director-General of the Banque de France and a TAC advisor, offers his own point of view, on the economic and financial views, with total editorial freedom. Email : jppatat@tac-financial.com