IREF
Fiscal Competition & Economic Freedom

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# Financial & Fiscal Features Newsletter

INSTITUTE FOR RESEARCH IN ECONOMIC AND FISCAL ISSUES

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In this issue:




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IREF's FFF Newsletter brings you monthly our analysts' exclusive inside scoop on latest trends in European central banking and financial markets, and their likely future impact.

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## Will Germany and Netherlands be able to prevent ECB QE? Is Weidmann becoming isolated in opposing Asset Purchases?

CENTRAL BANKS

**by Gordon Kerr and John Butler, with Enrico Colombatto**

***Only two countries remain opposed to QE, although even they realise that measures about to be implemented are QE in all aspects but the name. Meanwhile, ground is being prepared for ECB to shift blame if "unconventional stimulus" ends up not working***

Only a dwindling number of bankers or market practitioners see either an exit strategy or an effective outcome for Europe's monetary policies. Even ex US Treasury Secretary Timothy Geithner recently ridiculed Europe's hopeless position. Referring to tensions at a G7 Canadian summit in February 2012, he said "I completely underweighted the possibility that [Europe] would flail around for three years". Further, a year end survey by the Financial Times of prominent European economists showed virtually no confidence that anything the ECB might do to stimulate European growth would be effective.

click to continue to next page

## European Banking in the context of mounting tensions with Russia

FINANCIAL MARKETS

**by Gordon Kerr and John Butler, with Enrico Colombatto**

***Russian sanctions work. Or so we are led to believe. However, it would be a mistake to underestimate the preparedness of EU banks (and bankers) to sidestep official sanctions and participate on the market. After all, Russia's collateral may be sounder than that of EU governments...***

So pleased are Western leaders with the success of their sanctions against Russia that even President Obama chose to ridicule Vladimir Putin during a December television interview. Seizing on reports that Putin's tactical superiority over the West during the bulk of the year, particularly regarding Ukraine, had elevated him to the geopolitical equivalent of a chess grandmaster, Obama let fly: "He's presiding over the collapse of his currency, a major financial crisis and a huge economic contraction… that doesn't sound like someone who's rolled me or the USA".

### Russia & mainstream media

Mainstream media rallied behind this interpretation of events. The perennial end-December slew of reflections on 2014 and predictions for 2015 produced the usual variety of forecasts for equity and bond markets, but on Russia they all agreed. Putin is now

click to continue to p3



*The **Institute for Research in Economic and Fiscal Issues** was founded in 2002 to establish an efficient platform to investigate fiscal and taxation questions. Eager to cross knowledge from economics, statistics, law studies and politics, IREF seeks to create a starting place for thoughts and proposals about taxation policy.*

CENTRAL BANKS

## (cont'd) Will Germany and Netherlands be able to prevent ECB QE?.....

### Toothless ECB?

Starting the new year where we left off in December by far the most important, if not exactly the most nail-bitingly exciting, story continues to be the tussle between ECB President Draghi and Bundesbank President Weidmann, whose support is dropping.

A month ago, we reported that the ECB's 6 person Executive Board had split in half, with representatives from Luxembourg, France and Germany voting not to endorse a policy statement framed around a putative € 1 trillion programme of quantitative easing. Of course the wording of the policy statement talked about "asset purchases", rather than quantitative easing, and the nature of the argument left open the possibility of the dissidents endorsing the actual policy of QE.

*...we suspect that having lost the debate inside the boardroom, President Draghi has called on his supporters to intimidate the Bundesbank over the remarkably compliant media airwaves.*

### Shifting sands in ECB

As predicted, this furious row has now become very public. Indeed, we suspect that having lost the debate inside the boardroom, the tactically astute President Draghi has called on his supporters to pressurise the Bundesbank over the remarkably compliant media airwaves.

On December 17, France's Benoît Coeure gave a Wall Street Journal interview in which he indicated that conditions "were now suited" to QE and that he "saw broad consensus" at the top level of the ECB. Mainstream media reported the interview with deference and without mentioning his previous stance.

The Dutch remained supportive of Weidmann, albeit in less forthright language. Klass Knot, head of "De Nederlandse Bank" and therefore an ECB Governing Council member, stated that since Europe's political leaders had not agreed to such a level of risk sharing, the ECB should not bring it in 'by the back door'.

Under almost unimaginable pressure, Weidmann still robustly defended Germany's stance shortly before Christmas. QE, he reiterated, threatens financial stability, reduces incentives for governments to implement reforms, and its legality is at best questionable. However, crucially he accepts the need for the ECB to 'tackle' the perceived risk of deflation with Eurozone inflation dropping to an annual rate of 0.3% in November. He has not objected to the last few months of TLTRO (ultra-cheap long term bank loans), or private sector asset purchases such as securitisations and covered bonds. Even to Weidmann, QE must seem a relatively small next step.

### QE by any other name

The issue now revolves around the perception of debt mutualisation, which has been renamed "risk sharing". An absurd compromise has been proposed, whereby QE could take the form of government bonds being purchased by national central banks using ECB new money, but only a fantasist can see a distinction between this and direct purchases by the ECB.

*When QE is indeed introduced and promptly fails to stimulate, there will be no come back on the ECB; the problem will be ascribed to failings in the work of the European Supervisory Board for banking (ESB*

Draghi looks determined to drive this through at the January 22nd meeting. He is not renowned for timidity, and has an excellent feel for timing. No sooner had Greek Prime Minister Samaras triggered new elections following a no-confidence Parliamentary vote over his Presidential nominee, than Draghi, sensing his opportunity, gave an interview in Germany's Handelsblatt to raise the stakes: "There is a common misconception that the euro area is a monetary union without a political union" was but one barb aimed in the direction of Holland and Germany.

### Scene set for scapegoat

Also deployed to sway increasingly nervous German citizens to embrace QE was Peter Praet, the ECB's Chief Economist. A speech he delivered in Washington on December 9th was reproduced on the ECB's website. He stated that although TLTRO and covered bonds had been a "powerful response" to "dysfunctional banking channels", there is now unanimous support among the Governing Council for "additional unconventional stimulus".

The only doubt as to the effectiveness of direct interventions in the sovereign bond market in terms of lowering household borrowing costs, according to Praet, is the health of the banking system of each country.

**Regular readers of this monthly Newsletter will understand our dismay. When QE is indeed introduced and promptly fails to stimulate, there will be no come back on the ECB; the problem will be ascribed to failings in the work of the European Supervisory Board for banking (ESB).** ■

return to p1


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FINANCIAL MARKETS

## (cont'd) European Banking in the context of Russia...

reeling both from sanctions and the oil price decline, he is now in domestic political trouble, and therefore has little scope for further provocative actions. He faces a Hobson's choice: either to seek a grovelling détente, or to hunker down and cut Russia off from Western markets behind a new financial iron curtain, and hope to improve trading relations with Asia and China. Most media commentators, banking and investment analysts, expect the latter.

The reason for such broad consensus is that none can see any possibility of a Russia/ US rapprochement that leaves Russia with any dignity. No matter how small the concessions that Washington's diplomatic experts might request in return for lifting the sanctions, they will be too great for Moscow.

### What media are forgetting

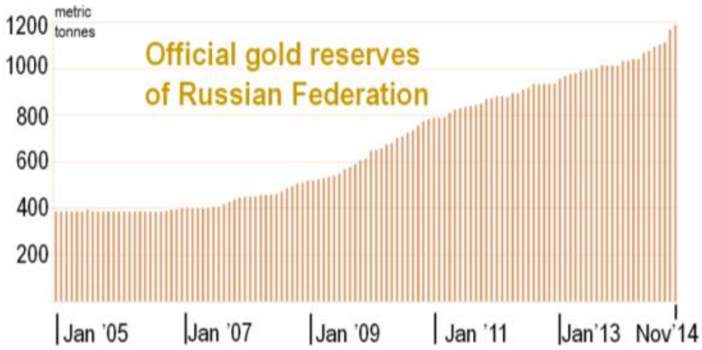
The flaw in this analysis is that it is based on an exaggerated view of two things. Firstly, of the level of international political support for sanctions (a widely reported concern); secondly the ability of politicians and central banks to control investment markets (less widely reported).

By misunderstanding the second point, none of the mainstream have picked up on surely the most likely and appealing of Russia's options, namely to sidestep diplomatic channels and simply engage directly with market-based investors in order to both strengthen the rouble and correct misperceptions of Russia's economy as fundamentally weak.

*None of the mainstream have picked up on the most likely option for Russia: to sidestep diplomatic channels and simply engage directly with market-based investors in order to both strengthen the rouble and correct misperceptions of Russia's economy as weak*

Specifically, Russia has vast reserves of genuinely hard assets: energy, commodities and precious metals including gold. Gold alone could back about a quarter of its narrow money supply at present prices. (The comparative figure for the US is 4 per cent.) Some of these assets could be used to back a programme of derivatives or securitisations that would attract western capital and effectively negate the effect of the sanctions.

Therefore, even leaving aside the obviously diminishing international support for sanctions, whilst it is clearly possible for politicians and central bankers heavily to skew markets via monetary policies, such powers do not extend to preventing large investment funds, desperate for positive yield, from purchasing such rock hard asset-backed investments that Russia might offer, if properly structured.





*Banks, or more specifically senior bankers, are primarily financially self-interested, rational actors, doing whatever they can within the rules of the changing supervisory framework in order to maximise personal cashflow*

### EU bank(er)s want to deal with Russia

Where would that leave European banks, equally hungry for yield but presently legally prevented from lending to Russia? Their perception of a hard asset is nothing stronger than any EU government bond. Our banks are no fans of the sanctions. Under ECB pressure to magic up some growth in Europe's shrinking economies, the last thing they wanted was to be compelled to call in high yielding loans to solvent Russian banks and businesses. How would our banks respond if the Russian government went down this path?

This Newsletter has consistently explained how banks, or more specifically senior bankers, are primarily financially self-interested, rational actors, doing whatever they can within the rules of the changing supervisory framework in order to maximise personal cashflow. And the changes continue to help. Practices such as collateral rehypothecation, high frequency trading to front run customers, and underreporting of expected loan losses have all been validated by recent rule tweaks in this framework during 2014. When bankers go a little too far and are called to account for serious rule breaches, the penalty is merely a fine of a billion or so of surplus liquidity which most of these banks have been cajoled into accepting from central banks in the first place.

**For such actors, preservation of the bank's existence is key to personal economic self-preservation.**

**Even if the sanctions hold in all 28 European countries, it is not difficult to imagine new derivatives, accounting tricks or other investment arrangements to enable sanctions to be circumvented.** ■

return to p1

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EU states can *already* deny welfare to non-residents. Nothing new. But this makes reform even more difficult **1047**

### 10 Myths Busted on Fin. Transaction Tax

We dispel 10 popular myths about a "Robin Hood Tax", supposed panacea to many contemporary ills. **1046**

### Raise withholding? Very bad idea.

Behavioural economists propose higher withholding to prevent tax cheating. We show bad side-effects.**1044**

### Fiscal Christmas 1: Partridge in Pear Tree

EU taxpayers are paying to protect habitat which they are also forced to pay to help destroy. Cruel paradox **1051**

### Fiscal Christmas 2: Turtle Doves

EU states continue to dictate what people should eat. They tax "bad foods" they subsidise. Another cruel paradox **1052**

### Fiscal Christmas 3: French Hens

USA play Game of Chicken when it comes to debt increases. It may be preferable to EU (non)solutions **1053**

### "Water Tax", the Ire of Ireland

Protests in Ireland against charging for water. IREF shows that though it's *not* tax, it increases taxation **1030**

### Deutschland Wages Über Alles

Germany introduces its first minimum wage ever. It distorts wages much more than in UK or US. **1023**

### Tax cuts aren't always good

Italy nicely illustrates that tax cuts need to go hand in hand with spending cuts, otherwise it's dangerous. **1033**

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- Le patchwork Macron mérite d'être soutenu
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