Bleak Optimism & Slight Hope

(© by Dr. Angel Gavieiro Besteiro; 21/03/16)

1) Bleak Optimism…

I am a frequent reader of articles at Project Syndicate (a very commendable effort to provide free high quality contributions from political leaders, policymakers, scholars, business leaders and civic activists around the world). Recently I read three articles by Stephen S. Roach[1], Adair Turner[2] and Sylvester Eijffinger[3], about the decision of some central banks for pushing the interest rates to negative territory, and its implications towards economic growth.

I agree with the authors that after keeping record low interest rates since 2008, engulfing trillions of dollars of assets via QE, playing with all type of formally-unorthodox verbal commitments and now making the interest rates negative, central banks are running increasingly out of ammunition to have any influence in the current economy.

Also, I share the views of many of my fellow commentators at Project Syndicate that, still, after all that effort, the panorama is ugly:
- We are in record-high indebtedness, globally, in both developed and emerging countries as per Debt/GDP ratios (in aggregate, 20% more than in 2007); and it is not clear whether or not we have passed the threshold for this debt becoming "excessive".
- We are in record-low interest rates and yield curves, in some cases negative till year 7 in the curve; all fruit of the global QE, plus the oil-crisis-driven "risk aversion" effect from the sell-

[1] "Central Banking Goes Negative" (18/02/16; Project Syndicate)
[2] "Are Central Banks Really Out of Ammunition?" (08/03/16; Project Syndicate)
[3] "The ECB Goes Rogue" (18/03/16; Project Syndicate)

off in equity markets, with flows moving into “safe” heavens (Bunds and US Treasuries).
- Banks do not lend as they potentially could, as manifested by the huge excess reserves; this behavior has been caused by the necessary post-2008 re-regulation, unavoidable credit risk aversion, and also lack of investment/consumption pull from the real economy.

Like many commentators, I doubt negative rates will change that situation much, and more likely they will make the eventual prickle of the global bond bubble worse (e.g. at current ultra-low rates, a 1% sudden positive jump in yield mathematically drives a circa 10% fall in bond prices for 10 year bonds).

Thereby, the conclusion is obvious: once spent all the monetary weaponry, it all comes down to looking for alternative ways of <u>recovering the Confidence</u> of the real agents, so that companies come back to invest and populations to consume. But how?

As Mr. Turner rightly points, in Keynesian times a Public Sector would kick-off with a large and sustained public investment/expenditure, however I am of the opinion that current times are not Keynesian anymore: today's governments do not believe they can finance it.

Let’s review the arguments behind this critical point. After the post-2008 crisis pain, taxes are a “no-no” politically for most democratic countries, and also they have an important contractionary effect on consumption to be reckoned with, which, given that a large part of GDP growth in the developed world depends on consumption, sharp tax increases could offset the intended growth effect. Debt is another “no-no”, since most of the governments today display record high Debt/GDP ratios, and most of them (but for Germany & US, for different reasons) feel that probably that debt is definitely "excessive". I believe it is impossible to determine a “threshold” for this concept, because it is intrinsically dependent on changing (sometimes even highly volatile) markets expectations. Then, why that fear? because everyone witnessed how markets reacted against the Eurozone government debt during 2011-13, a time where clearly markets decided that debt levels were “excessive” for some Southern Eurozone countries; in addition, nowadays, most of the countries’ public and private sectors have to refinance their debt in these markets, quite often with an important participation of easy-to-frighten foreign investors.

In some way, this period of history shares many similitudes with the 30s, only that the ensuing depression has been barely held at bay, camouflaged behind the 2008-09 huge Public Rescue by governments and subsequent QE by central banks; however, the deflationary shadow has been pulling us down all along since 2008, and does not seem to go away.

The ultimate driver behind this complex situation, in my interpretation, is a ***Huge Lack of Confidence*** (as F.D. Roosevelt reminded us, *"the only thing we have to fear is fear itself"*)... and we have not seen, so far, global leaders with the required statesmanship and appropriate “cause to rally” to really start to tackle this enormous challenge.

So what? Well, I am afraid the developed world is in a **catch-22 situation** without a nice exit; I believe, under these circumstances, any exit will necessarily require huge pain (much bigger than the 2008 crisis); more likely than not it will happen in an uncontrolled way (no soft landings) probably sparked from the frictions out of the competing interests of <u>worldwide economic blocks</u>, aggravated by an everyday increasing level of <u>geo-political conflict</u> and <u>global remilitarization</u> (I am afraid these 3 drivers are inevitably connected).

Apologies for the bleak optimism offered, but I cannot find rational arguments to support any other conclusion... appreciated contrary views.

2) …Slight Hope

Thus, I challenged myself to provide a contrary view to this bleak optimism. Our admired Albert Einstein, comes to the rescue with some of his many quotes of wisdom: *“we can not solve our problems with the same thinking we used when we created them”*.

The “same thinking used” within the description of the previous section, I believe could be identified with the way we usually contemplate monetary and fiscal policy, within countries or blocks (i.e. EU vs US vs BRICs vs Japan…). Therefore, “different thinking” would mean to find solutions that transcend these boundaries, so solutions that are necessarily global.

Hence, in the “hope part” of this essay <u>I advocate to totally depart from an EU-centric approach</u> because, by the very nature of the paradigm shift argued in the previous paragraph, a real solution is not possible within one country or block (like the EU), it must be a global solution. Now, the EU could become the leading flag bearer in pulling the rest of the world in this direction, and an EU leader like, for instance, Mrs. Angela Merkel (among others) could step up her statesmanship to this global challenge.

So, what potential global solution am I advocating?

All along the problem solving effort for the <u>Global Economic Crisis</u>, we have been trying to tackle another global challenge: <u>Climate Change</u>. This one, because of its very nature, we knew we could only solve when we find solutions that transcend national boundaries. In Paris, in Dec.15, for first time a timid global agreement was found (even on scant terms).

Thus, why not we put both challenges, Global Economic Crisis and Climate Change, together and try to find a <u>combined solution</u>? The first reaction would be, no way, too complex. But, let’s think for a moment: would not they be both sides of the same coin?

At the end of the day, to tackle effectively Climate Change requires a monumental effort that result in the coordinated rearrangement of economic resources (i.e. human and financial capital) to achieve a series of tangible objectives that eventually would curve the global warming threat. The required economic resources must stem from the current global economic system, which it happens to be in crisis. Thus, whether we would like to recognize it or not, both problems are intimately intertwined.

Thereby, this purpose looks to me a more than worthwhile cause over which we can build a ***Huge Amount of Confidence*** if the global leaders put their thoughts and actions to it. We could engineer a new way to coordinate our monetary and fiscal efforts, globally, to tackle specifically this Climate Change challenge, which itself, if the effort is large enough and sustained for a prolonged time period, it should become the opportunity we need to exit from the Global Economic Crisis.

Moreover, this idea elicits also a historical consideration: in the decade of the 30s, relatively similar circumstances happened, which conduced to the effective exit of the continued global economic depression and subsequent lack of growth of that decade; this exit came from a coordinated global effort where enormous amount the resources (i.e. human and financial capital) where put at stake: unfortunately, World War II. And yes, let's remember, the very concept of the EU stemmed and evolved as a permanent coordination effort among European countries to avoid that something like this would happen again in this continent.

Today, in the XXI century we live through circumstances that again could lead us to undertake a global effort, either by repeating the mistake again (e.g. God forbids, WWIII), or by learning from history and so channeling our efforts instead to fight a war against a common enemy of humankind (created by humankind itself): **Climate Change War (CCW)**.

Now, for this CCW we need to think of the usage of our weapons at hand, i.e. monetary & fiscal policy, in a very different way: we need to think globally. What could this mean in practice? Here it goes <u>my starter-for-10</u>:

- All Central Banks worldwide would make a large and simultaneous QE exercise, in all their respective currencies, to buy CCW Bonds.
- IMF/WB would issue the CCW Bonds with bullet maturities distributed along the range of 20-30 years (perhaps even longer), with coupon grace until year 10, priced with some aggregated world government benchmark curve.
- IMF/WB would invest the raised proceeds in CCW Projects allocated directly among all the world countries, with a majority of Public/Private sector participation across a large variety of industries and following a prioritization in terms of (1) CCW impact and (2) Employment impact (in particular for young generations).
- At the same time, each Government receiving allocations for CCW Projects from their country would underwrite a Future CCW Tax Commitment, off-balance-sheet, which would be put in effect starting from year 10 onwards, and that would focus on income from Companies (following criteria proportionate to their past & future contribution to global warming) and Individuals (following progressive criteria to reduce wealth inequality). This tax would be levied by governments on behalf of IMF/WB.
- From year 10, Governments would start raising the new CCW Tax and remit the proceeds to IMF/WB for the servicing of CCW Bonds, which as they were maturing would be amortized down by the respective world Central Banks, until eventually eliminating all the money that was created in the first place (30 years later).
- Needless to say, the crux of the whole deal would be to reach an agreement on:
  (1) at global level, the distribution of money creation by Central Banks and money distribution across Governments for CCW Projects;
  (2) at national level, the distribution of CCW Taxes between Companies and Individuals; and…
  (3) of course, the amount of global QE required to effectively win CCW.
- Finally, with regard to the crucial matter of CCW Projects, I leave this discussion for other people more qualified than myself on this topic, as many have been the efforts so far in researching and suggesting technologies and practices to effectively fight Climate Change across a wide variety of industries. The key aspect here is to ensure there are clear and uniform criteria for measuring the impact in terms of contribution to reversing Climate Change and to sustainable employment generation.

This solution provides 2 critical elements, <u>a credible global cause</u> and <u>winning time</u>. This is the rationale behind how effectively it tackles the catch-22 earlier described:

- By gathering the whole world, with their political leaders at the front, against a common cause (CCW) we would generate both the high amount of confidence that was lacking and a tremendous amount of resources (human and financial) to invest.
- These resources would be raised and utilized from the IMF/WB balance-sheet, and the utilizations would be allocated to individual countries but without creating any further burden to their respective public sector finances, as still would reside in IMF/WB balance-sheet, and for the individual country would not mean anything else than accepting a forward CCW tax for servicing their quota of resource utilization received; this tax does not start until the first 10 years have lapsed.
- Also, CCW bonds would not trigger any dreaded reaction from capital markets as their servicing, via the CCW taxes levied at individual country level towards IMF/WB, will not be required during the first 10 years. It is important to notice that the average maturity of the outstanding debt of most countries is lower than 10 years, so IMF/WB's CCW bonds are in practice subordinate "in time" to the markets getting repaid the outstanding debt of individual countries, which as we know stems from each country's current and future taxes.
- Besides, these resources would be deployed on CCW Projects over a long period of time, which should generate gradually but surely a recovery of investment as direct consequence of the CCW focus, and, as associated jobs and business expectations rise, also should generate a recovery of consumption. Thus, creating the so aimed sustainable economic growth.
- This economic growth ultimately would help to reduce public deficits, via volume effect on current taxes, and effectively deleveraging the public sector balance-sheets; private sector deleveraging would follow as increased company profits and increased employment savings start to flow to repay outstanding private debt.
- Once arrived at year 10, hopefully we would be in a situation where balance-sheets would be able to take the new CCW Tax without fully offsetting growth.
- Then, governments would gradually pay back the bonds to IMF/WB, who would pay back to Central Banks, who could then eliminate the excess cash created in the system when all started (leaving neutral the CCW effect on global monetary base).
- Thus, in 30 years, we would be back to a healthy economic environment in a healthy planet. That is the legacy that we all want for our descendants.

A main counterargument would be that this solution would create a future tax burden for the next generation to shoulder. However, I would argue that the burden has already been created with both the Climate Change and the current Global Economic Crisis. Our generation has the obligation, at least, to put in place a sustainable solution so that, even if the next generation needs to shoulder part of the solution's cost, we ensure that they will not bear the much more harmful negative outcomes of what we created.

✦✦✦

Not a small ask, let’s face it… however, and given what is at stake, could we think of anything more important, for ours and next generations, in which to bet such an enormous global effort than CCW?

Moreover, given the current high level of geopolitical conflict and global remilitarization, would not an ambitious and coordinated effort like CCW help to mitigate and reduce these other two threats by re-channelizing first political and, subsequently, human and financial resources to CCW?

Of course, if we put back on the old lenses that we are used to wear to think about our current problems, the idea above would look like Quixotesque, at minimum. Nevertheless, it is thanks to Quixote’s ideas that humanity has been able to push through the frontiers of what we thought was possible and provide all of us with the illumination and welfare that we have been enjoying until today, which at this point is at serious peril. Was not the foundation of the European Economic Community by the Treaty of Rome back in 1957 a similar Quixotesque challenge?

Thus, why not? What do we have to fear, other than fear itself?

To my son, Diego… so that his future and that of his generation could be brighter than ours.

Dr. Angel Gavieiro Besteiro
Abu Dhabi, March 21st 2016