Suggestions for European Economic Reform

Mickey D. Levy

Chief Economist, Bank of America

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The health of the financial services industry is determined in large part by Current and expected economic and financial conditions. In this context, let me make several observations about economic and financial market performance, and provide some suggestions about economic policies important to sustained healthy growth.

1. The ECB's bank lending program has been very successful in addressing European bank's short-term funding squeeze and contributing to lower bond yields in key nations like Italy and Spain
   - While Europe is making progress on some of its troubling economic issues, let's be clear about the easing financial conditions stemming from the ECB's bank lending program. A sizable portion of the recent declines in sovereign bond yields has occurred because the ECB's program removed "tail risk" of a near-term sovereign financial collapse, which has led private portfolio managers (largely US) to play the positive carry game and buy sovereign bonds, knowing that European banks would be doing so.
   - Also, now that the ECB is operating as lender of last resort to banks, it will be unable to exit this policy thrust anytime soon, and banks and sovereigns will continue to require financial support that only the ECB can provide. Thus, the ECB's lending program is likely to be elongated and enhanced.
2. The ECB's bond purchases and liquidity facility to banks is only a "stop-gap bridge loan" and is ***not*** a substitute for either fiscal austerity or true economic reform.
   - It only buys time to accomplish true reform, and markets may still lose their patience and test the resolve of policymakers and the credibility of their policies
   - The ECB's unprecedented balance sheet expansion and absorption of risky assets is unsustainable, and its ultimate success hinges critically on whether the necessary fiscal austerity and economic reforms are enacted and implemented.
3. European policymakers have shown their commitment to "doing anything it takes" to avoid financial crisis and/or breakup, but economic prospects will remain dim until reforms—fiscal

and economic—are implemented, and perceived to be credible by businesses as well as financial markets.

- The current recessionary conditions, high unemployment and the need for significantly more deleveraging in both the nonfinancial (particularly household) and financial sector make the enactment and implementation of reforms difficult.
- Presently, while I believe the recession will be mild, and most European economies will resume growth in the second half of 2012, it's appropriate to ask: in the absence of meaningful reforms and a distinct reduction in uncertainties, can domestic demand resume healthy growth? What are the prospects for exports, particularly by some EU nations whose international competitiveness has eroded?
- Remember, even before Europe's financial crisis, the Eurozone's potential growth was notably weak, with a sizable variance around the average.

4. The poor economic performance in many European nations stems from excessive and burdensome government—in spending and taxing, as well as regulatory and labor policies—and lack of competitiveness stemming from the rising gap of wages relative to productivity—these issues must be addressed.
   - Germany's healthy economic performance, driven largely by exports, is the largest exception. It is noteworthy that Germany's outperformance results from a half-decade of painful reforms that involved significant constraints on wages amid strong productivity gains, and a shrinking of government relative to GDP. Those reforms were difficult and lengthy. Germany's experience with reform underlies its tough bargaining positions in the current policy debate.
5. Based on US experiences and my understanding of what markets want, as European policymakers address the needs to enact and implement economic reforms—regulatory, labor, political patronage, etc. and fiscal austerity—***the goal of policies must be to strengthen sustainable, long-run economic growth and restore competitiveness.***
   - ***Pro-growth reform initiatives must be emphasized as much as, or even more than fiscal austerity.*** Improperly designed fiscal austerity programs may harm domestic demand. Establishing deficit targets (as part of new governance parameters) that are likely to be violated due to recessionary conditions would only damage credibility and would be a setback. Growth, allocating resources more efficiently and eliminating laws and practices that contribute to current inefficiencies in labor markets and production processes, and restoring competitiveness, should be the focus.

- Sustained economic growth is a necessary requirement for improving government finances (reducing debt/GDP ratios), private sector deleveraging and the recapitalization of the banking industry. Failure to grow would pose mounting problems on all fronts.
- Markets and businesses and potential foreign investors (financial and foreign direct investment) are looking for reforms geared toward long-run growth prospects and competitiveness.
- Taxes in troubled EU nations are already so high that raising taxes further in an effort to close budget gaps would be counterproductive and harmful to economic performance.
- Financial markets agree with me on this point that growth is the key, and they will respond positively to pro-growth reform initiatives.

6. Needed economic reforms—properly designed to improve functioning of labor markets, provide more flexibility in production processes, increase competitiveness in a wide array of tradable and non-tradable industries—will take time to work to generate growth.
    - Accordingly, policymakers must ***manage expectations***, in the media, financial markets, among politicians, and in the population in general. Don't expect instantaneous gratification from reform initiatives. But patience will pay off in terms of sustainable economic growth and permanent job creation.
    - Avoid reliance on temporary quick-fixes—they don't forward objectives and lack credibility
    - Some policy failures in the US provide examples of what to avoid. The Obama Administration's short-sighted fiscal stimulus package of 2009, which was geared toward temporarily boosting the economy, failed and only increased government debt, did nothing for future productive capacity or permanent job creation. In contrast, a properly balanced long-run fiscal compromise in the US, which would reduce the long-run budget gap and reallocate resources toward activities that would increase productive capacity (education, skills, infrastructure) would build credibility and reduce uncertainty—key ingredients for sound economic performance.
    - Financial participants and businesses quickly recognize whether policies are credible and have a chance to work.
    - ***Setting fiscal targets*** may disappoint expectations, as recessionary conditions reduce tax receipts—and dashing expectations and ***harming policymakers' credibility***. Even cyclically-adjusted fiscal targets are risky; tax receipts tend to fall shy of expectations during recession.

7. ***Policy leadership***—based on the proper long-run pro-growth vision—and ***credibility*** are critical to success.
    - I understand the importance of the EC's agenda to improve governance and regulatory frameworks, but true economic reforms are the necessary foundation for growth and maintaining and increasing standards of living.
    - Well-designed pro-growth economic policies will build credible leaders
    - The challenge now is to get on the right side of that virtuous cycle.