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In this issue:

Central Banks and Governments Increase their Market Presence and Controls

Central Banking

by Gordon Kerr and John Butler, with Enrico Colombatto

Confidence in the ECB wobbles as commentators on all sides question the effectiveness of supposedly growth stimulating new policies.

The ECB announced a range of new measures on June 5th, including setting a negative interest rate for the first time. The details of the June policies are as follows:

ECB Rates	Before June 5th	After June 5th
Ordinary Lending Rate	0.25%	0.15%
Emergency Lending Rate	0.7%	0.4%
Rate paid on Deposits	0%	-0.1%

In addition, starting in September, the ECB will introduce a new programme of long- term loans to banks which lend to the private sector. And it will also continue a programme of quantitative easing (€165 billion) by putting on hold its programme of "sterilizing" previous bond purchases. First introduced in 2010, when it started to buy government bonds of heavily indebted countries, the ECB used to withdraw on a weekly basis from the banking system an amount of funds broadly equivalent to the total of such purchases. The practice has now been suspended.

Economic situation

These measures were clearly prompted by fears over the prospects of recovery in the Eurozone.

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Markets and Investment

by Gordon Kerr and John Butler, with Enrico Colombatto

At least two big takeover deals are being negotiated in Europe now, both with heavy government involvement. The strategies adopted by the French and UK governments may appear to differ but at heart they are very similar.

The US economy remains the dominant driver of investment markets. This is why the first-quarter data coming from America should have been worrying: GDP contracted by 1%, exports fell by 6%, and corporate earnings were down by 3.4%. Yet the US stock market continued its resolute climb.

Part of this phenomenon can be explained by Quantitative Easing and loose money. Part comes from the fact that some US companies continue to look to Europe for growth and expansion. In particular, two major potential transactions played out during last month: General Electric made its €12.35 billion bid for the energy division of Alstom (France), and Pfizer tried to acquire UK-based Astra Zeneca. What links the two stories is the level of involvement of the French and British governments respectively.

GE—Alstom

France's Minister of the Economy, Arnaud Monteborg, reportedly summoned Alstom's Chief Executive to his ministry as soon

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*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 Banking (cont'd from p1)

Q1 GDP growth was a miserly 0.2%, unemployment remains stuck at around the 12% mark, and inflation for the year to May was confirmed at 0.5%. The inflation number vexes the ECB most, because in order to maintain the central bank's own optimism that at some point countries such as Greece will get their debts under control, a much higher level of inflation must exist.

Banking remains moribund; vast amounts of losses and asset value overstatements are still hidden in the balance sheets of many of the largest banks.

The media initially welcomed the measures as a courageous step in the right direction, And it is undeniable that today's markets are exceptionally calm compared with two years ago. They are calm because investors' expectations about future central bank policies have become more consistent. Yet, this calm has not prevented commentators from arguing that the time for cagey promises and threats is past, and what is now needed is much stronger stimulus in order to jump start economic activity and restore inflation to the 2% target.

IREF's position

We agree that these policies will achieve little, but disagree with the analysis behind the calls for stimulus.

Our view is that the dire situation of Europe's insolvent banking system has never been fully appreciated by the central banks or the mainstream media. Banking remains moribund; vast amounts of losses and asset value overstatements are still

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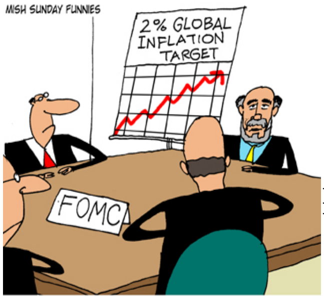


source: globaleconomicanalysis.com

"Good News: Inflation is well above our 2% target in China, India, Egypt, and the UK.

... Markets and Investment (cont'd from p1)

as he heard of the putative transaction, demanding an explanation as to why Alstom was negotiating without involving his department. At the time of writing, it looks as if the deal will proceed, but only after GE has issued assurances about job creation in France. The level of government involvement reaches into the deal itself, with the Ministry reportedly pressing for a joint venture arrangement in order to retain some management control in France. This it justifies by references to preserving the French government's stewardship of its "economic nationalism".

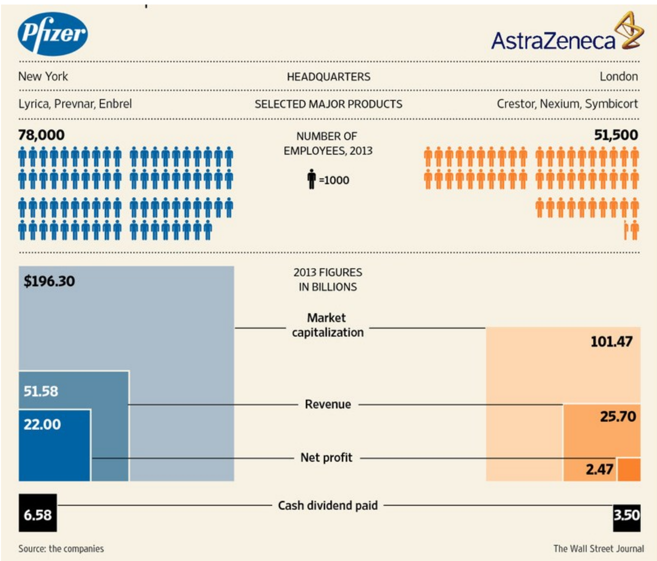
Pfizer-AstraZeneca

Although the UK coalition government is more committed to the market economy, its response to Pfizer's bid for AZ was no less muted. The government's official position may have been "neutral". Nonetheless, a Parliamentary committee demanded assurances on jobs and research spending, and the Department for Business, Innovation and Skills took up the jobs issue under the pretext of its anti-trust role. The government of Sweden, where AZ has a strong presence, lent its support by also objecting to the bid. The final nail in the coffin was the exposure of a potentially delicate trait: tax optimization. Pfizer did not deny that it would save US taxes by relocating its head office to the UK, where it would pay only a 21% corporation tax rate compared to 35% in the US.

French government justifies its involvement by references to preserving the government's stewardship of its "economic nationalism"

Because the approach was hostile, and because Britain's takeover rules involve a strict timetable, the opposition of both UK and Swedish governments helped AZ run out the clock. The bid approach lapsed at the end of May. Unions breathed sighs of relief, and the media reported that the UK takeover timetable should allow the US enough time to 'close the tax loophole' before Pfizer is able to consider a renewed approach.

"Closing a tax loophole" is more or less a euphemism for tax unification, or at least harmonisation. No doubt this issue is much wider, and undoubtedly constitutes a significant part of the recently renewed talks on a Euro-American free trade zone.



(infographic: Wall Street Journal)

... Central Banking (cont'd from p2)

hidden in the balance sheets of many of the largest banks. The interbank market remains non-functioning in spite of the fact that the banks

- have used ECB facilities to offload illiquid assets,
- have benefited from low interest rates to sell liquid assets at higher prices, and
- have recapitalised using new hybrid capital instruments.

Problems continue because banks have been re-leveraging via new practices such as collateral rehypothecation, which, as we have previously reported (see January '14 Newsletter), undermine mutual confidence in one another's solvency. Put differently, banks have reduced certain activities in order to improve reported numbers, without any lessening of appetite to seek out new forms of leverage. This amounts to a slow, drawn out process of formal deleveraging.

source: dailybail.com

The dreaded D-word

Further still, this is also deflationary. Why? Other factors being equal, banks' behaviour depresses lending and the speed at which money circulates through an economy. Of course, countless factors determine price rises or falls, bank leverage being only one. However it is a potentially important factor, given that the euro has not depreciated, and that QE in Europe has barely even started. There can be little doubt that the ECB worries that further deleveraging is being encouraged by its own review of the solvency and asset quality of Europe's major banks. What is beyond doubt is that Eurozone inflation remains unexpectedly low, and is regarded as the main threat to recovery. Our view, by contrast, is that this is not unexpected at all, but simply reflects the inhospitable business environment created by massive and still unresolved private and public debt overhangs, and so-called "austerity" policies which take the form of higher taxes rather than lower public expenditure.

Public finance in Eurozone

Indeed, the public-finance situation in much of the Eurozone has hardly improved. Two years ago, the IMF published a report taking stock of the previous years of austerity. It found the multiplier associated with fiscal tightening to be larger than previously assumed. This means that, for each unit of fiscal tightening, there was a greater economic contraction than anticipated. This resulted in a larger shrinkage of production and had the unfortunate result of pushing up the government-debt/GDP ratio, the exact opposite of what was desired.

> *Banks have reduced certain activities in order to improve reported numbers, without any lessening of appetite to seek out new forms of leverage*

Dissenting opinions

Today, other prominent sources have voiced similar caution about the state of monetary policy. For example, several members of the UK Monetary Policy Committee recently expressed concern about the risks posed by a financial sector that remains highly leveraged. Their conclusion was that central bank policy should change focus from inflation targeting, which demonstrably failed to prevent 2008, and instead address money and credit growth. This is, in other words, the opposite of present ECB policy.

In a similar vein, Jaime Caruana, General Manager of the Bank for International Settlements, recently stated that very low interest rates had been fostering "unbalanced expansions" and were making life difficult for small economies in particular. He concluded:

> *[T]he implication is that there has been too much emphasis since the crisis on stimulating demand and not enough on balance sheet repair and structural reforms to boost productivity. Looking forward, policy frameworks need to ensure that policies are more symmetrical over the financial cycle, so as to avoid the risks of entrenching instability and eventually running out of policy ammunitions.*

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28 shades of grey
The truth behind media hype about Italy artificially boosting its debt picture by including prostitution in its GDP figures.

Are EU elections bad for democracy?
EU election turnout is always lower than national one, but it then acts to lower the next national turnout. Bad news.

Living wage in EU
Many want employers to be obliged to pay living wage, not just minimum wage. Yet IREF calculates that minimum often already exceeds it.

New ocean found
Cypriot government violates one of bailout conditions by lifting ban on officials travelling business class. Flagrant opulence or illegal subsidy?

Visibility of taxes & tax competition
Tax harmonisation as prevention of race-to-the-bottom? What race? Invisible taxes increase the most.

Fiscal effects of election turnout
IREF reviews evidence on turnout alone being able to influence post-election fiscal spending & tax rates. (It can.)

Swiss referendum on min.wage & EU
Swiss are not crazy voting on astronomical minimum wage. It's because they can vote easily, unlike in the rest of EU

Piketty's fallacious statistics (study)
Like Marxists, he endeavours to transform his discourse into a scientific demonstration. It's new scientific materialism.

Distance from Brussels matters
Compared to last election, EP2014 turnout went down in countries far from Brussels but went up in those closer to it.

FR.irefeurope.org

Où est la fraude? C'est si facile de trouver des boucs émissaires!

Les bricolages statistiques de Piketty

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