March 2015

Financial & Fiscal Features Newsletter

INSTITUTE FOR RESEARCH IN ECONOMIC AND FISCAL ISSUES

Fiscal Competition & Economic Freedom

EN.IREFEUROPE.ORG /IREF Europe EN @IREF_EU

In this issue:

Greece Will Have a Plan B by June – the ECB Will Not

CENTRAL BANKS

by Gordon Kerr and John Butler, with Enrico Colombatto

The ECB's deal with Greece still leaves it exposed. Despite the rhetoric that countries must get their own finances in order, the ECB's sister agency has started work on a new programme of $319 bn of mutualised debt.

Syriza had only been in power for two weeks when the European Central Bank cut Emergency Liquidity Assistance (ELA) liquidity to Greek banks, an odd decision since it severely weakened the very banks who had been re-capitalised with $48bn of the $120bn 2012 bailout funds. By June, it is possible that Syriza will have contingency arrangements in place along the lines outlined in our last Newsletter. It might then be in a position to demand debt relief with the threat of repudiation, which would put the ECB under great pressure.

*click to go to **next page***

***Last page** can be printed out separately and displayed on a public noticeboard, if you want to help us in our mission. Thank you.*

American Stress Test Results – Testing by Central Banks May Be Worse Than Pointless

FINANCIAL MARKETS

by Gordon Kerr and John Butler, with Enrico Colombatto

US banks all pass their stress tests. However, that is not necessarily reassuring. When central banks took over testing from ratings agencies, can they be trusted that they would reveal problems potentially leading to a premature panic? UK banking may have some problems to solve.

The US Federal Reserve has just announced that all 31 banks it tested have passed stress tests, meaning that they are deemed to have sufficient capital to survive a stressed scenario enduring 9 quarters. This is the best set of results from any tests since they started in 2009. Does this indicate that banks are in better shape? Almost certainly not.

Stress testing by central banks of the commercial banks which they supervise (large complex companies), as opposed to stress testing by rating agencies of asset-backed securitisation vehicles (simple, single-purpose vehicles often bulk administered by a third party trustee) is a novel, recent and questionable extension of central banks' remits.

*click to go to **next page***

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.

Subscribe for free at

http://en.irefeurope.org

*This **Newsletter** is published monthly to all e-mail subscribers. You can subscribe through the website and unsubscribe anytime. Your email will not ever be given to anyone or used for any other purpose. Past issues can be found in the Archive section of the Institute's website. (New issues are added after a small delay).*

*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) Greece will have Plan B...

Greek debt is now largely in the hands of its own domestic commercial banks and the ECB. According to Deutsche Bank, the ECB and other public institutions own 80% of Greek debt. This changes the political calculus in Germany and elsewhere as non-Greek banks are not directly exposed. This makes the odds on a Greek default now more, rather than less, likely. Austria has now chosen to bite the bullet, rather than kick the can, by bailing in all Hypo Alpe-Adria creditors, even senior creditors, and including the regional government of Carinthia which seems likely to declare bankruptcy. If Austria is prepared to do this, other central banks might follow suit since there are many banks in a similar condition in Spain and elsewhere.

> *ECB and other public institutions own 80% of Greek debt. This makes the odds on a Greek default now more, rather than less, likely.*

We are interested in the timing. What suddenly happened here? Could it be that Austria's bad bank was exposed to CHF-linked mortgages or other CHF-linked debt? Such CHF structures were quite popular in Eastern Europe in general.

Debt Mutualisation – Happening Now

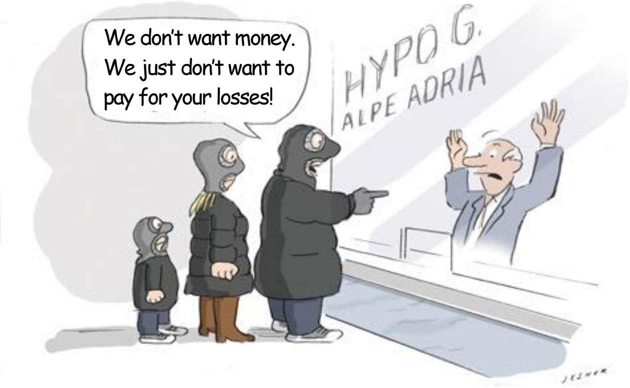
Whilst the ECB maintains the line that Greece and other countries will be compelled to fix their problems through economic growth, the European Investment . A €315 billion fund is being created whose only purpose appears to be to enable national governments to circumvent the budget balancing rules that supposedly apply under both the Stability and Growth Pact and the 2012 Fiscal Compact, which limit annual deficits to 3% of GDP, for example.

Only incepted in November 2014, EFSI (European Fund for Strategic Investment) has already received applications from every European government, in total for 2000 projects costing €1.3 trillion. But it is the structure of the fund that is of most interest. The only equity capital in the fund will be an initial injection of €5bn, and even this will be 'created' by revaluing existing EIB assets whose prices have risen thanks to ECB monetary policies. This will be supported by European Commission guarantees of €16bn. This €21bn figure will be used to obtain €63 bn in loans from other public institutions, which will be expressly subordinated in order to back public bond issues for the balance of €252bn.

> *ECB maintains that Greece and others will have to to fix their problems through economic growth, the European Investment Bank's recent infrastructure fund appears to undermine the ECB*

Although countries whose projects are approved will assume interest payments, they will all be borrowing at the same rate. This is debt mutualisation in plain and simple language.

return to p1



(cont'd) American Stress Test Results...

FINANCIAL MARKETS

Whilst the rating agencies now use deeper and more varied stress scenarios than they did pre-crisis, the Fed applied only one stress scenario, and a soft one at that. In the Fed's stressed scenario, house prices would fall by 25%, US stock markets by 60%, unemployment would rise to 10%, crude oil would rise to $110 per barrel, and US GDP would fall by 4.5% from its present level. It is obvious to all that stock prices reflect heavy gearing and are inherently volatile, unemployment has recently been around the 10% level, oil was in the range of $110 in the past two years and although a 4.5% drop in US GDP would be considered sharp for an economy that dipped in nominal terms by only about 3% in the Crisis, by the standards of European nations this drop seems relatively modest . Furthermore, for mortgage backed securities to obtain AAA ratings, the agencies have typically assumed that house prices would fall by 60%, so 25% is not a "worst case" stress by such an objective yardstick.

Nonetheless, the Federal Reserve reassuringly announced that the 31 banks' aggregate Tier 1 capital levels would represent a healthy looking 8.2% of Risk-Weighted Assets under the stress scenario, an improvement from the comparable 5.5% output of the first round of tests in 2009. This compares favourably with the Fed's benchmark minimum of 5% and the old (pre-crisis) Basel test of 4%. But have we not been reporting for more than a year that global regulators have hailed the new Leverage Ratio [link NL February 2014] rule precisely because of their misgivings about the game-ability of Risk Weighted Asset rules?

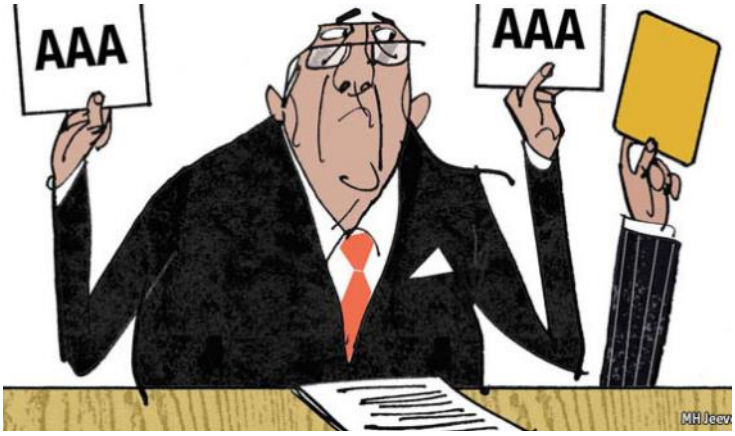
Haldane pre-scrutinised the tests

In 2013, the Bank of England's Andrew Haldane published a paper "Holding a Tiger by its Tail" demon-

click to continue to p3

FINANCIAL MARKETS

(cont'd) American Stress Test Results…



strating that from 1994 to 2008 average risk weights of bank assets fell from 70% to 40%. Haldane's point is that, by wearing rose-tinted spectacles when applying internal, self assessed risk weightings to their own assets, banks have flattered their Tier 1 ratios. For example, a loan pool that should really have been internally assessed as AA risk would typically have been reported to the central bank as AAA. By so doing, the banking industry managed to excise on average 30% of the nominal risk exposure from the RWA capital adequacy calculations despite, as we now

know, the actual riskiness of banks' assets increasing. This gaming of the capital adequacy rule was, according to Haldane, blindingly obvious because during the same period average leverage (total unweighted assets compared to capital) rose from around 20 times to well in excess of 30.

By wearing rose-tinted spectacles when applying internal, self assessed risk weightings to their own assets, banks have flattered their Tier 1 ratios.

Even the US Treasury poured cold water on the Fed's stress test news. A new limb, the Office of Financial Research, published last week a paper dismissing the entire exercise as pointless. The tests, they argued, are bound to predict that banks will survive.

"Whereas the results of stress tests may be predictable, the results of actual shocks to the financial system are not, and therein lies the problem."

Moral hazard makes stress testing worse than pointless

The increased responsibility placed upon central banks by requiring them to stress test national banks simply highlights a problem of moral hazard; between the central bank and its stakeholders, politicians and the public. Consider the likely reaction to publication of results suggesting that the banking system was not in good shape. Such results would immediately undermine the central bank's credibility by highlighting all the time and resources it has applied to the problem of restoring banking health. Further, politicians would likely oppose publication of such results; concerned that such news might itself provoke a run on banks and thus trigger a fresh crisis. For these reasons, we consider central bank stress testing of banks to be not pointless, but worse than pointless, in that it encourages naïve stakeholders to have more confidence in banks about whom they might otherwise make greater due diligence enquiries.

Evidence of problems in banking continues to arrive almost daily. In London at a recent Parliamentary scrutiny committee, Bank of England Governor Carney reported that he has referred 42 cases of alleged serious misconduct such as market rigging to the BoE's sister institution, the Financial Conduct Authority. Astonishingly, these allegations concern officials at the Bank of England itself, and on March 4th the UK's Serious Fraud Office announced it has placed the Bank of England under formal notice of investigation into its allegedly fraudulent conduct of multiple securities auctions dating back to 2007.

We predict that wobbles in European banking will soon reappear, irrespective of what actions the ECB and Greece take in June (or earlier). This may result in some form of major macro event.

What this means for the future

Given the present condition of the banking system in Britain and much of Europe, we predict that wobbles in European banking will soon reappear, irrespective of what actions the ECB and Greece take in June (or earlier). This may result in some form of major macro event.

Ironically, although Europe's present leaders dread this outcome, they should welcome it. It will surely lead to precisely the reforms for which they presently call; national budgets to be, if not balanced, well within the Maastricht criteria; banks – no longer propped up by central banks - compelled to engage in credible accounting policies to appeal to market creditors. This should be welcomed as a European economic renaissance.

return to p1

INSTITUTE FOR RESEARCH IN ECONOMIC AND FISCAL ISSUES

« Fiscal competition and economic freedom »

http://en.irefeurope.org

IREF

February 2015

Latest articles on our website:

*(Scan the QR code with your smartphone to go to that article, or enter **en.irefeurope.org/XXX** where XXX is the number listed)*

Guide to World of negative interest
What was considered impossible is now reality. People are paying to part with money. Why? We explain **1074**

Econ. freedom down €-zone, up outside it
Decomposition of 2015 economic freedom index shows some improvement in the EU, mostly outside the € **1066**

TTIP: new wave of corporatism?
Trade provisions are good, but investment part has seeds of enhancing corporatism in EU and USA **1067**

New EU deficit rules encourage profligacy
The 3% deficit is no longer binding, in time for Italy to break it. As long as you label spending "investment" **1068**

Greek debt is not at all crippling
Greece should pay 4.6% interest, but with refunds and deferrals it's already close to Germany's 2%. Fair? **1069**

Russians call on Putin for bailout
It's not just banks. Now individuals who gained private benefits want to share out costs **1071**

France & Planned Obsolescence
In what's probably world's first, France has outlawed planned obsolescence. We outline consequences **1076**

Fiscal health is more than debt
What government statistics usually miss are mandatory payments for future pensions and healthcare. **1075**

Croatian debt cancellation
Removing debt from the poor may help the economy, but not by blackmailing foreign investors in country **1073**

FR.irefeurope.org

- Pour sauver l'agriculture, supprimons les subventions
- Retraites complémentaires AGIRC-ARRCO
- Il vaut mieux encourager les «retraites chapeau»
- Attali ou l'imposture par démagogie

DE.irefeurope.org

- Griechischer Schuldendienst nicht lähmend
- Deutsche Bahn AG auf Abwegen
- Staatsfernsehen teuer und obsolet?
- Selbstanzeigen von Steuerhinterziehern

This page can be printed separately and pinned to a public notice-board

***From IREF's Mission**: Tax authorities are currently under the strain of two opposite forces: centralisation and harmonization on one hand, devolution and competition and globalization on the other hand. 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. In order to achieve its goals, IREF is editing books, reports and academic studies on topics related to taxation. IREF's experts are covering the European current events related to taxation and economic policy and you can find every week on our website their comments and analysis.*