CHAPTER 1

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MACROECONOMICS, STRUCTURAL REFORMS: RECONSIDERING THE BANKING MISSION, BETWEEN FINANCIAL RESTRAINTS, SHAREHOLDERS EXPECTATIONS AND MONETARY POLICIES LESSONS, IN A SINGLE CURRENCY MARKET

ABSTRACT

Most of the studies conducted in the past eighty years by economists: lately (Mundell, 1999), (Eichengreen, 2004), (Eichengreen and Sachs, 1986), (Friedman and Schwartz, 1963), (Bernanke, Laubach, Mishkin and Posen, 1999), have shown conflicting perceptions about the great depression, even after a long range of studies of evolving situations and the present recession. Such efforts should have definitely shown some tangible evidence, trough some trial and error evidences.The current literature indeed seems to be still hesitant about the full benefits of political and monetary policies and everywhere new studies about structural reforms are appearing. From the operative sectors, comes out some serious approach like (Koo, 2009), with his Holy Grail of Macroeconomics, lessons from Japan's Great recession, which (Krugman, 1998), supporter of the monetization of Government debt, has generally attributed to deflation as the sole direct cause. We must not ignore the frustrated hope of the Bank of Japan, as it embarked since 2001 upon recurring everlasting quantitative easing facilities. Consistently it was a confident hope as well of the central banks in the United States and Europe in the years 2008 – 2009, with their foray into quantitative easing trough TARP and LTRO, and some similar procedures, erratic in their effect, as long as one of the currency, the dollar, is the only left international liquidity pillar instrument.

Now the pressing of structural reforms seems to replace some previous monetary policy therapies, but there is no specific definition or any agreement about their meaning, which seems to be confusing the *economic policy planners with final huge debts and liquidity traps, that are affecting most of the present QE guidelines.*

This paper wants to consider and propose some structural reforms guideline, in order to clear, at least, from a semantic point of view, the content and scope of such remedies, starting from the uncertain credit and monetary supply approach leading to essential structural reforms.

Key words: monetary, fiscal policy, structural reforms prosperity and development

JEL classification: G21

1. <u>INTRODUCTION</u>

There is a sequence of interlinked events, starting in August 1971, that lead trough a single converging economic path that may clearly, specify and explain the present situation, in order to face the present world social economic perspective, the role of the banking industry and its necessary adjustments. As *structural reforms* has become the common language used by our three big global financial players, the IMF, the World Bank and the BCE, for what relates to the EU and its members and associates, it seems to me necessary to stress on the premises to outline the structural reforms as possible remedies in a definitely new environment.
My constant opinion is that the starting point of the present financial and economic crisis is long dated and the decision may be stemming from the dollar debasement on the 15 August 1971, after one week of discussion at Camp David and mostly due to the panic and stress. After a quiet prosperous long golden period of economic rebuilding and developing, both national economies devastated by the Second World War and the international payment system, were rebuilt over the dollar backbone, after the unsuccessful efforts to restart it in the Roosevelt era. Since then, the macroeconomics and most monetary policies have become a common unsuccessful too long term playing tool, defined *Holy Grailof Macroeconomics* (Koo, 2009) in an exponential growth of prices, values and markets turbulences and altered functions, from a huge inflationary wave in the 70's until the global economy produced a new unexpected deflationary recessive environment. The effect of the

’71 debasement was a joint free monetary base expansion and related multiplied quantities, the general adoption of fiat money and the missed solution to the trade imbalances. Assuming structural characteristics in a world divided by oil dollar surpluses, usually the dollar reserves landed in Europe and formed

- the huge euro-dollar market,
- the ongoing cold war divisions,
- the progressive partition in strong and weak currencies,
- the secondary COMECON clearing balances market.

The latter with a substantial loss on the Swiss market of multilateral clearing balances, when stemming from the ex COMECON (Council for Mutual Economic Assistance area) used to loose aver 20% of their value becoming weak currencies in a fixed exchange rates world.

Figure 1 Currency and Coin Circulation U.S.

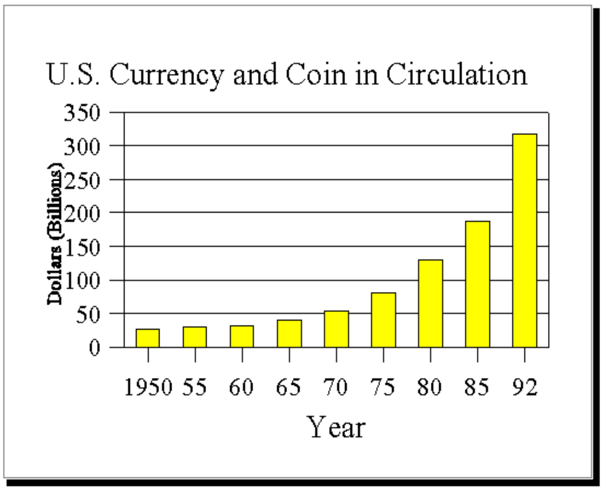
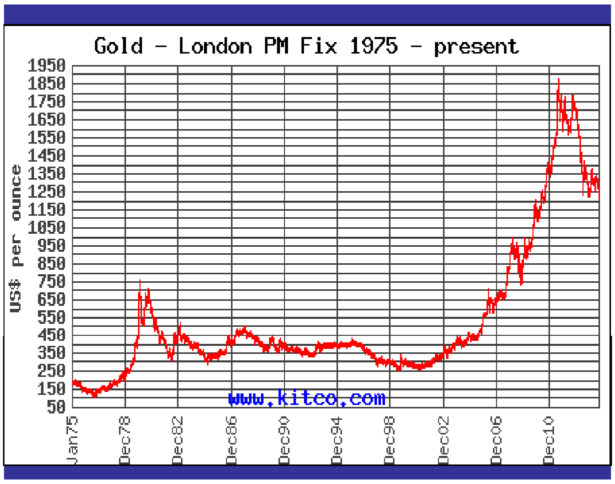


Figure 1: United States currency and coin in circulation for selected years since 1950. Source: *The Treasury Bulletin*, March 1993; U.S. Government Printing Office, p71. See *Table 1* in the *Appendix* for the supporting data.

Finally, the surge of gold price, when declared negotiable in the free market for the first time after the 1935 central banks restricted exchange area negotiations.

Figure 2 Gold – London Fixing -1975 Present



Same effects are visible on the oil pricesand on the consumer price indexes.

Figure 3 Oil prices

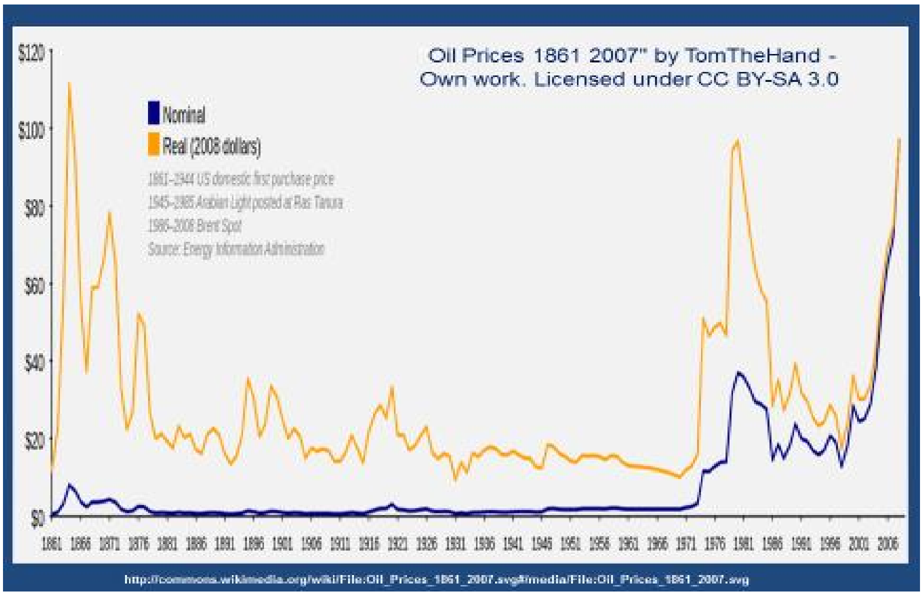
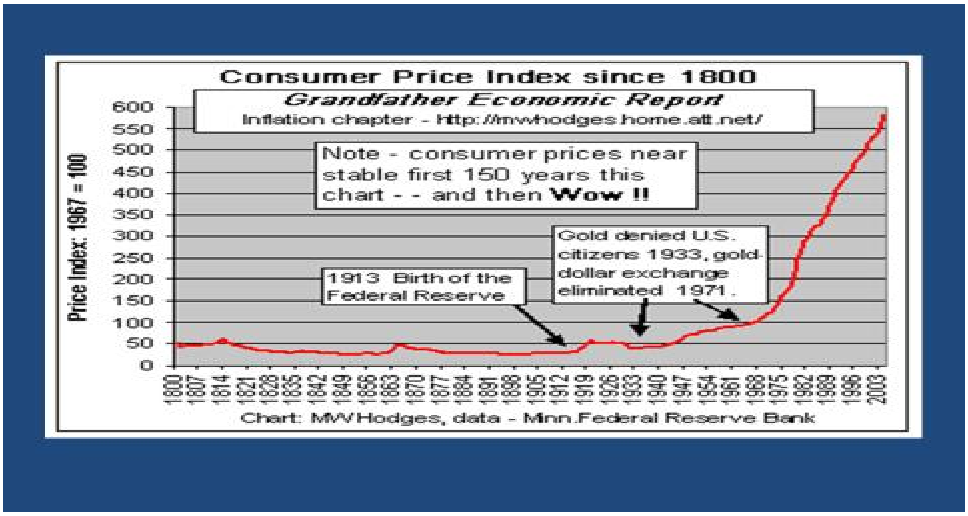


Figure 4 CPI



On a worldwide basis, the structure of the present economic situation starts with the superficial attention given to the dollar debasement and the failure of the world fixed exchange rates currencies. The previous international monetary system started just three weeks after the landing of the allied troops in Normandy, at Mount Washington hotel, in a New Hampshire Carrol Village, at Bretton Woods, when both the World Bank and the IMF surfaced to face the reconstruction and the general indebtedness at the end of the Second World War.

The first tangible impact of the debasement was a fall of the dollar value in terms of gold, just after the December 1971 Smithsonian Agreement that adjusted the fixed exchange rates established at the Bretton Woods Conference of 1944. Although the other currencies remained pegged to the dollar until 1973, the main difference with the previous regime was the abolition of the dollar's convertibility into gold, guaranteed by U.S. Treasury, making the dollar definitely a fiat currency and gold a free commodity.

This paper wants to link some basic structural revision, as outlined in a confused literature, during the fourth following decades and the role banks played in the general markets' turbulence. In this very long period, most of the consequences of: "This broadly held notion was quietly shelved by the breakout of Keynesian economics from the heady cloistered atmosphere of academia to the - practical world - of everyday American politics" (Greenspan, 2014:184), succession of events

interlinked in a strict row of interdependent consequences, rarely jointly considered.
Furthermore, Greenspan remembers in the year 2006 - after his dismissal from being a vested interest – that, when John F. Kennedy introduced the new frontier concept and the removal of the heavy fiscal drag during the 60's, a "…. coterie of academic economists, schooled in the early version of what we now call Keynesian macroeconomics,"[1] made their first appearance. The public saving was then leading to the landing on the moon, before becoming the public debt black hole after the debasement.
The major collateral effects were, on the contrary of what is happening today (Heinemann and Friedrich, 2000:20) " … therefore, taking low inflation rates and tax reforms together the presumption seems well founded that fiscal drag comes to an end. This can also be stated in the context of Wagner's Law: Government expenditures can only grow as far as additional revenues can be raised. Finance or privatization proceeds are exhausted in most countries, taxes are crucial. This study indicates increasing marginal political costs of tax financing a rise of public expenditures. For a given income elasticity of the demand for public goods this tends to restrict the scope for a future Wagnerian expansion."

This problem that by that time the young Kennedy thought to somehow overcome, became a major issue during the 70's, with a high inflation leading to the stagnation, with the indiscriminate deficit spending and the indexation in most Countries of wages and salaries.

2. SOME PRELIMINARY REMARKS

The developments that trailed the dollar debasement were indeed a huge deficit spending, under the Keynesian postulation that the economy would react positively to the demand fall out. In reality, during the 60's, the economic community found out a new topic to discuss indefinitely, the *stag – inflation*, showing no relationship between any public spending increase and economic activities in developed countries.
The *fiscal drag* by Kennedy's times seemed to be a tough issue, depriving the economy of essential demand because of excessive

[1]Idem. 103.

taxation, and bringing to the huge budget surpluses and, indeed, during most of the sixties the federal government net saving was in rare surplus.
A relevant tax cut in 1964 and the expenses to send a man on the moon were the forefront of initiatives to face the growing rare budget surplus. Since then, a political bipartisan match to face the seeds of the historic entitlement boom to the social welfare redistribution programs.
During the 70's the surplus disappeared and a new deficit era started to emerge, from military spending to tactical fanfare reallocation of income over 9% in the year 2009. The deficit spending has become the main maneuver planned by politicians, supported by the huge inflow of petrodollar and Japanese investments first, Chinese trade surplus during the eighties successively.
The termination of the Bretton Woods agreements produced a visible confused fallout over most of the economies and a reversal of the dollar preeminence. The event, associated with the end of the cold war and the fall of the Berlin wall, brought the most dramatic consequences: the political U-turn of the Muslim world to the ex USSR and the start up of the jihad, the Taliban revolution down to the Caliphate regimes and the endemic spread corruption in the West.
The opening to the China exports, with the mutual recognition in the year 1979, and the consequent new US-China trade and financial relationship, signed in Washington in the month of January 1979, were basic turnaround pillars. The consequent huge economic growth of Asia, even though some local transitory currencies crisis, put on the market the overwhelming amount of progressive more qualified products at the lowest ever seen prices. It was due to the low labor wages, the huge volumes conducted to a surplus of financial instruments on the American capital markets joint with a lack of proper chances of economic investment, with a deflationary financial nominal growth of available capitals over most of remaining financial markets. Such environment was leading Japan, the USA and Europe to a stand still economic activity, under contradictory signs of growing monetary masses and lack of inflation signs, the new Chinese deflation syndrome.
Under these pre-conditions, the banking industry was deregulated and all the previous approaches, developed during the Great Depression, like the 1932 Glass-Steagall Act, removed, in a lobbing modernization trend, to the Gramm–Leach–Bliley Act 1999. It became so lawful to mix commercial and investment banking activities. The Dodd–Frank Wall Street Reform and Consumer Protection Act, as signed by President Obama in the year 2010 did not remove this situation.

3. THE EVOLUTION

The most sensitive and visible consequence of the new variable exchange rate has been the spread risk trough the financial markets, the enormous development of derivatives and financial transactions within a logic of speculative and short time investments. Then three decades characterized by the huge inflation: the 70's, followed up during the 80's by a counteraction, until the first financial bubble explosion in October 1987, the monetary supply in a macroeconomic perspective with a deep financial deregulation until today and still in effect. Then came the first serious bubble, the dot-com one over the NASDAQ, the sub prime and the derivatives at the end of the roaring 90's in the new millennium 2007-2008.

The two layers new world global markets, one local and one interlinked, trough the improperly denomination globalization, reflect the abolition of barriers and levies to the world trade. The new market horizon has privileged the low cost productions to modern car and electronic industries and seems to develop a new world equilibrium based mostly on basic interlinked complementary synergy on both demand and supply side, according to the Adam Smith model, where competition is essential because prices then reflect minimum costs and highest quality. Without competition, prices would rise, quality would weaken, and the consumer choice would falter. Indeed, it might be no better than a system where prices seem dictated by a government or by a mercantile system.

As generally used by the policy makers during the three last decades in the 20th century, modern macroeconomic models were under scrutiny already at the end of the Century. (Lukas, 1996:262) was writing: "But who can say how the macroeconomic theory of the future will develop, any more than anyone in 1960 could have foreseen the developments I have described in this lecture? All one can be sure of is that progress will result from the continued effort to formulate explicit theories that fit the facts, and that the best and most practical macroeconomics will make use of developments in basic economic theory."

Furthermore, " It is no wonder that the integration of money into a neoclassical framework has been so difficult to achieve: neoclassical economics is fundamentally incompatible with the most important functions of money, which - as a medium of exchange - is to free people from the need to know the V, price of n-1 goods at all the times. Money exists because the real world is fundamentally non neoclassical. Money and Walras do not mix." (Koo, 2009:308)

4. THE DOLLAR FUNCTIONS

As the dollar is a surviving international payments sole instrument, and the euro has not succeeded to replace it in the world central banks currency reserves, there is no chance to see temporarily an alternative to a full set of structural reforms. Monetary policy must be tested, clearly, structured and inserted in a full scale of error and trial proceedings.
The need of a currency to be used as an international mean of payments is so stringent and undisputable that since the first worsening of the USA foreign debt structure and the consequent weakening of its mean as a purchasing power preservation storage, no substitute was discovered.
The oil standard first and the gold surge later up to 2000 dollar an ounce, discovered a new scenery where the London Big Bang and the deregulation later kept the same USA currency as a reserve currency without valid concurrence. So, during the inflationary 70's, the Volker efforts to curb the inflation in the 80's and the roaring deregulated 90's, nothing changed the world financial assets from a progressive expansion of the dollar notwithstanding its intrinsic value and debasement.

5. THE CRISIS

The following economic developments, from a geographical, sectorial and country crisis experiences are well known and have been converging to the center, most developed Countries, a simple record of the most relevant ones:

- S&L crisis 1980
- Japanese banking crisis 1990
- December 1994 and early 1995 Mexico - Tequila Crisis
- Argentina
- Brazil
- The Philippines
- Poland
- 1997 Thailand
- Indonesia
- Malaysia
- October 1997, Korea
- August 1998, Russia declared a debt moratorium
- January 1999, Brazil suffered an exchange rate crisis

- Lehman Brothers
- Bear Stearns
- Merrill Lynch
- Morgan Stanley
- Goldman Sachs

While too big to fail, Bank of America, Freddie Mac and Fannie Mae in order to survive in the roughest times by their own received large Federal subsidies.

Starting in the 2008, the US Treasury, under the Bernanke guidance and the Troubled Assets Relief Program (TARP), added $250 billion to some bank equity, the equivalent of 2% to the equity capital-to-asset ratio.(Greenspan, 2014) Such a practice was started by the Federal Reserve Board for the first time in decades, with recourse to the obscure and explosive section 13 (3) of the Federal Reserve Act. The section empowers the Board to lend nearly unlimited cash to virtually anybody; on March 16, 2008, it empowered the FED Bank of NY to lend US$ 29 billion to facilitate the acquisition of the investment bank Bear Sterns by J.P. Morgan.

The huge recourse to the deficit spending principle, as outlined in the General Theory, inefficient to stimulate the employment figures as in the stagflations years 70's, has been as well no sufficient to guarantee, apart from the monetary nominal debt clearing, the actual structures and assets to supply the promised real economy recovery. The spiral monetary demand - supply and real economy actual output are under the tough concurrence of the prevailing global and overall Asian, effective supply based on classical microeconomics supply side standards and models.

There is no alternative but an involution of the Western economies through policies based on expanding *fiat money* State deficit, prevailing entitlement, reducing progressively savings and investments in a scheme of Welfare State. Referring model, where most of welfare relates do interlinked public expenses linked to mafia type propping up to big to fail concerns, out crowding firms toward a *crony capitalism* as foreseen by (ALAN GREENSPAN, 2014:249).

As far as I have faced the dollar debasement experience, starting in the year 1971, the trend lines and evolution described in my papers and most of the not *vested interests* activities have converged toward both the mixed economies failure, the collapse of state planned economies and the final resurgences of the Eastern Asian tigers under competing market microeconomics models.

While many aspects of the Great Depression are still debated, there is an universal agreement that the adoption of restrictive trade policies was destructive and counterproductive and that, similarly, any form of barriers in our current slump should be avoided at any cost. This happens as long as the critical size of any modern enterprise, in order to remain competitive, requires an over the borders market. There is no room for a local economic activity, apart from the local artisanship's and specialized productions like clocks and jewelers, slowly disappearing as well. Lacking other instruments with which to support economic activities, governments erected during the thirties tariff and nontariff barriers, in a desperate effort to direct spending to merchandise produced at home, rather than abroad, without great success as the 1928 last Dow Jones quotations surfaced in the market only in the year 1956, after the Second World War. As all other governments were likely responding equally, the distribution of demand across countries remained unchanged at the end of this round of global tariff hikes, in a useless multilateral clearing system, similar to the one promoted within the new Soviet economy. The main effect was to resize trade, which, despite some economic recovery in most countries after 1933, failed to reach its 1929 peak until the second postwar period, and after the Harry Dexter White proposal surfaced at Bretton Woods, disregarding Keynesian vision of gold as a barbaric relic.
The benefits of comparative advantage were then lost. Recrimination over unilateral trade policies made it more difficult to agree on other measures to halt the slump (Eichengreen and Sachs,1986:67-71).

6. SOME NEW WEIGHTED APPROACH

The finalization of the European Union single currency, after several Basel Schutzenhouse restaurant meetings and after the (Padoa Schioppa, 1992) white paper on the payments and clearing system issue, became a mandatory point in the recent European monetary union history. After the roaring 90's, the technological productivity improvements have distorted the attention from the real evolving macro system monetary quantities, no more defined from gold as an external compulsory limit to the unrestrained public spending, and the euro seemed to represent, after the collapse of the Berlin wall, the end of history according to (Fukuyama, 1992). Fukuyama supported the thesis then prevailing that free trade had rendered territorial enlargement goals obsolete and that war had become economically irrational henceforth counterproductive.

When after the 9/11 2001 attack to the towers, the Business weekly review entitle its coverage "The day the world changed", something really new was appearing on the economy setting of a confused world, where macroeconomics was dying and a new trade imbalance was confusing both monetary authorities and economic political planners. The new bubbles millennium opens with a classic huge one, resembling the South Sea Bubble. The John Law Mississippi monetary scheme, hit the dot.com NASDAQ quotes. Two other identical events followed, the sub - prime one and the linked derivatives third, which are faced within the President's advisor committee mainly formed by old fashioned Keynesians in new fiat money monetary system.
The new financial world reminded the one depicted by (Mackay, 1841 and De La Vega, 1688) reprinted and commented by (Fridson, 1996) "..the more things change, the more they seem to stay the same. Nothing in our modern markets appear to make much difference, not the complexity of financial instruments, not the information overload, not the globalization, not the powerful insight of financial theory." Note that the year in which Confusion de Confusiones appears, 1688, "....was the same year that the English threw the Stuarts and took the first steps in the establishment of a constitutional monarchy. This dramatic break with the pas is the true beginning of the modern era."[2]

7. THE RESTRUCTURING PRESENT DILEMMA

Most of clear and present dangers come out of the relationship between deep deregulation and macroeconomic restructuring, financial guidelines requirements, enforced by the lending Authorities, mostly the IMF, the WB, the EBC and the political cost of both reshaping the public administration and reforming the welfare state as grown trough the cold war years and later. A free market economy is not able to allocate savings and investments according to political guidelines and it seems very difficult to obtain wide unconditional consensus, as long as the State is a factor of increasing public demand from a private consumption angle.
As a readjustment from a public swollen consensus demand, pursuing politically prearranged goals, to a concurrent contraposition between a civil society attitude and a contribution on a single member partnership

[2]Idem. Viii.

statute, to a passive bargaining political consensus, based on individualistic vested interests. The gap seems to be insuperable and not likely absorbed by available instruments.

"The financial crisis that began in the summer of 2007 should therefore be understood as an accelerator of an already well-established trend of relative Western decline" (Ferguson, 2011). The consequence is a declining low profile welfare society, facing a new wave of capitalistic instruments, operating from the global new growing competition out of the classic everlasting economic goals, based on value, synthetic expression adding quality and price in a single competitive environment.

The total growth of exports from Asia and the slow progressive substitution of western productions was leading to an economic supremacy which ended in a surpassing Chinese GDP over the leading USA, undiscussed lead after the second world war and up to the unsuccessful planned economy experiment in the Eastern hemisphere.

The survival kit left by the financial institutions would have been able to satisfy a strenuous defence of the dying welfare State privilege, which would have endured as long as the Eastern financial centres would have supported it.

Now we must face the overcome of Chinese GDP, larger then the USA one and the misleading welfare policy financed only by deficit spending supporters as well by China. Asia has regained its previous economic level it used to have at the beginning of the new world discoveries, which kind of structural reforms are we now supposed to endure in order to keep our present income untouched, this is the final undisputable problem.

8. CONCLUSIONS

First of all I would again stress that: "A primary aim of the economist is to understand business behavior rather than to make recommendations to businessmen. His understanding of economic processes provides part of the foundations for the analysis of the operation researcher." (Baumol, 1972:5)

The central problem is to discover, define and accept the new perspective understanding the mistake made under the false assumption that some transitory, usual public spending program, would have automatically absorbed the multifaceted crisis, arouse after three decades of old fashioned fiscal and monetary policy instruments, while new form of recession was unpredictably developing. This seems now not to be the case: the deficits are already at their upwards limits and slight resurgence interest rates may be able to put several States on the insolvency line simultaneously.

Structural adjustment programs (SAPs) may be a link to define the problem. They consisted of loans provided by the International Monetary Fund (IMF) and the World Bank (WB) to countries that experienced economic crises. The two Bretton Woods Institutions require borrowing countries to implement certain policies in order to obtain new loans (or lower interest rates on existing ones). The clauses conditionality attached to the loans were critical because of their effects on the social sector.

SAPs generally pursue the reduction of the country's financial imbalances in the short or medium term and, as well, to adjust the economy to long-term recovery perspectives. The bank from which a borrowing country receives its loan depends upon the type of necessity. The IMF usually implements stabilization policies as a bank, the WB supplies adjustment measures and acts as a fund.

SAPs were supporting the economies of the developing countries to adopt market structures. This then forces them to concentrate more on trade and production to promote their economy. Through conditions, SAPs generally expects market programs and policy.

These programs include internal changes like privatization and deregulation, as external ones, especially the reduction of trade barriers.

On the other side, the role Central banks assumed, after the gold standard demise, have headed progressively to a central role in supplying fiat money in too liquid financial markets directly or indirectly towards mostly political goals and Keynesian frameworks that didn't work.

Remembering what Walter Bagehot was saying in 1983, about the role of a central banker, the actual crisis made his remarks present and clear signs of what we could discuss today within the monetary chaos afflicting some unrealistic situation. According to Alice in Wonderland, impossible things may not happen, but the Irish Government issued in March negative interest rates bonds, over a sixth years maturity. Same thing did the Swiss Government, issuing for the first time in history negative bands over a ten years maturity, that zero rates structures within the Basel members are not indicating a return to normality. Argentina tried the impossible GDP linked Bonds, without notable success. Normality means that, apart from the operative cash flows, in microeconomics defined as the gross profit, accountable after tax and

depreciation, no saving and therefore no new investments are likely to start in the near future. At least as long as a fiat money payment and settlement system is operative in a recessive economic framework and in a multi Nations' area single currency system. Without savings, no future exists in most of Countries in term of economic or social progress in the Western hemisphere, designed to make the Bank as strong as possible, we should look at the rest.
"First. There should be a clear understanding between the Bank and the public that, since the Bank hold out ultimate banking reserve, they will recognize and act on the obligations which this implies; that they will replenish it in times of foreign demand as fully, and lend it in times of internal panic as freely and readily, as plain principles of banking require.
Secondly. The government of the Bank should be improved in a manner to be explained. We should diminish the 'amateur' element; we should augment the trained banking element; and we should ensure more constancy in the administration.
Thirdly. As these two suggestions are of our banking system, and try to reduce the demands on the Bank as much as we can. The central machinery being inevitably frail, we should careful and as much as possible diminish the strain upon it." (Bagehot, 1873:28)
It appears rational market pricing has been definitely distorted for a too much log time. Interest rates are too low to stimulate savings, and seem impossible the formation of highly required capital and the rationale economic fairness of monetary transaction over term maturities. Interest rates are definitely too low if the market were to drive interest rate levels, but that has not been the case since the days before the Great Depression. I wonder if a market actually exists, if not manipulated and reflecting contradictory objectives.
If growth would start to be rekindled in Europe, the days of nega-coupons may quickly become a memory, as inflation expectations could revive and rational marketing pricing structure discipline return. Under the present variables, higher interest rates are not compatible but with general Nationals payment default, without any perspective of short or medium term economic recovery, which case is not likely to happen.
The only solution possible is a new kind of Bretton Wood agreement, based on the perspective to overcome the real problem, the classic monetary functions crippled by half a century of deficit spending, not bearable any more and a starving capital efficiency expectations with a destructive taxation both substantially and formally too high. The only

reason why National deficit spending are sustained over a rationale expectations is due to the international law enforcements always likely to happen and a progressive dependence of excessively indebted countries, which may seem a temporarily asset to some creditor.
To a practical understanding of the present financial frozen world, in a nega-rates environment, we must say what follows. The single problem we faced during the 90's, with the soft landing expectations, ever recurring at the Senate Banking Committee Greenspan reports, now has been split into two separate issues; the financial and market indexes always monetary manipulated on one side, and the consumer price indexes, showing the long awaited and missing take off.
This bizarre two faces circumstance relates to the enlarging potential market on one side, with a tough competition on the labor costs and the fallout of the monetary policies, always pursuing the demand stimulus but promoting the financial nominal markets indexes alone.
We can understand the problem and resolve if we overcome two separate issues: a set of free market openings to pursue equilibrium values, and the interdependence between macro and microeconomics compatibility.

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