This Wounded Economy: Synchronized Slowdown. Recession Spelt With a Capital D.

The financial crisis rolls on. Failure to fully understand the first precipitation in 2008 is leading to errors in policy.
For example, Greece's insolvency is not the consequence of the GFC, it was exposed by it. Spain's sovereign balance sheet is unhealthy but not terminal, its banks' are. Similarly, Ireland fell for its banks. In both cases, real estate bubbles bursting were the root cause.

A greater principle is at stake, our model of capitalism. In its original form, capitalism was the disinterested arbiter of fortune and failure, symmetrical in reward and punishment. Since the early 1990s, and coincident with the demise of that dour alternative, communism, central banks and governments have come to favour reward, to the extent that an important element of capitalism, its natural selection, has been blunted. This is risky.

Just as the trader in the bank may win big but only lose his job (and not his own capital), so an asymmetrical regime encourages excessive or ill considered risk taking. With interest rates also a hurdle in the investment decision, lowering interest rates to bail out entire economies distorts price signals important in the allocation of risk capital.

Today's capitalists are socialists on the downside. Governments and regulators are spoiling a generation by sparing the rod. They are also weakening the breed. Many of the emerging market entrepreneurs are thriving against their western counterparts because fate has been a cruel teacher, because decades of corruption and expropriation by despotic regimes have steeled their resolve.

The Euro zone is but one manifestation of the dilemma. Saving Greece will encourage Italy, Spain et al to heave a sigh of relief and slide back into fiscal irresponsibility. And to what end? Saving Greece will require the combined Eurozone to bail out Spain and Italy. The Spaniards have already got themselves a head start with ‘not a bailout, but a loan with favorable terms.’ Terms which Ireland, Portugal and Italy are now studying with much interest. To renege.
The Euro group has two feasible paths to take, neither of which it has contemplated. The first is to let the lame ducks die, which is very un-socialist and will never find political support. The second is a system wide bailout sufficiently comprehensive that it ends the uncertainty that has plagued markets since summer 2010.

The current strategy of staving off disaster as and when it threatens is not viable. It means that the problem continues to grow while a solution keeps getting deferred.

The combined financial might of Germany is insufficient to recapitalize the rest of Europe, so debt monetization is a necessary intermediate step. The ECB will need to monetize member countries’ debt across the board. This is bad news for the Euro and risks inflation in the Eurozone.

Europe will require financial assistance on the scale and complexity of the Marshall Plan. It is hard to see which economy is sufficiently strong to provide such financial assistance given the global scale of the 2008 financial crisis. It is hard to see a way out.

Animal spirits need to be revived, but how. Monetary policy today is pushing on a string. Fiscal policy is unfeasible given the state of public coffers. Debt levels are simply too high. Much of the public debt was previously private. Government’s in an attempt to save the system assumed these debts, shoring up private balance sheets, whose principal’s today are shy of spending or investing. Keynes’ prescription would have been to spend on their behalf, yet perversely, the wherewithal to do so has been transfered away to them. Without investment and consumption, and thus growth, taxation to fund expenditure is futile. Perhaps expropriation is a last desperate strategy. It is sometimes necessary to nationalize the weak, but perhaps it is useful to nationalize the strong. If the idea is to tax and spend.

Macro prudential policies can be deployed to address the dual problem, encouraging investment and consumption. A tax on corporate net cash is a means of encouraging investment. Taxing earnings after capex is another. Pro growth policies involve reducing marginal taxation which with sovereign balance sheets in their current precarious state will be hard justify. They will be regarded as brinksmanship.

To recap.

Monetary policy is ineffective but must be undertaken as part of debt monetization. Austerity is self defeating but some measure needs to be done to quell market fears. Growth is the way forward but requires some brinksmanship. And Europe needs a system wide bailout.