Monthly Bulletin of Economic Trends

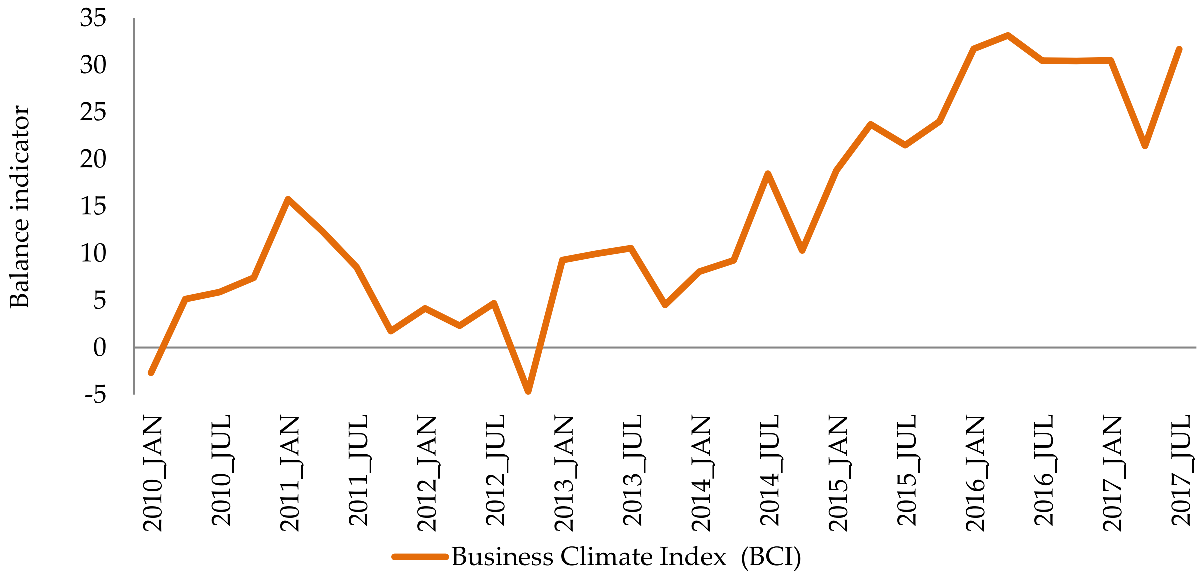
August 2017

Results of the IEER Quarterly Business Climate Survey – July 2017

The results of the latest quarterly business climate survey reveal favourable economic conditions compared to the previous quarter: the IEER Quarterly Business Climate Index increased from 21 to 32 points. This result indicates that following the decline observed in April 2017, the Business Climate Index returned to the value of around 30 points that had characterised it since January 2016. (The Business Climate Index was 34 points in the same period of the previous year.)

The increase of the Business Climate Index can be primarily attributed to businesses evaluating the current profitability, stock order and business situation more positively than in April. A slight decline since the previous quarter can be observed only in three indexes describing future expectations, namely the expected change in staff members, expected capacity utilization and expected production levels for the next six-month period.

Figure 1: Quarterly developments in the Business Climate Index, January 2010 – July 2017

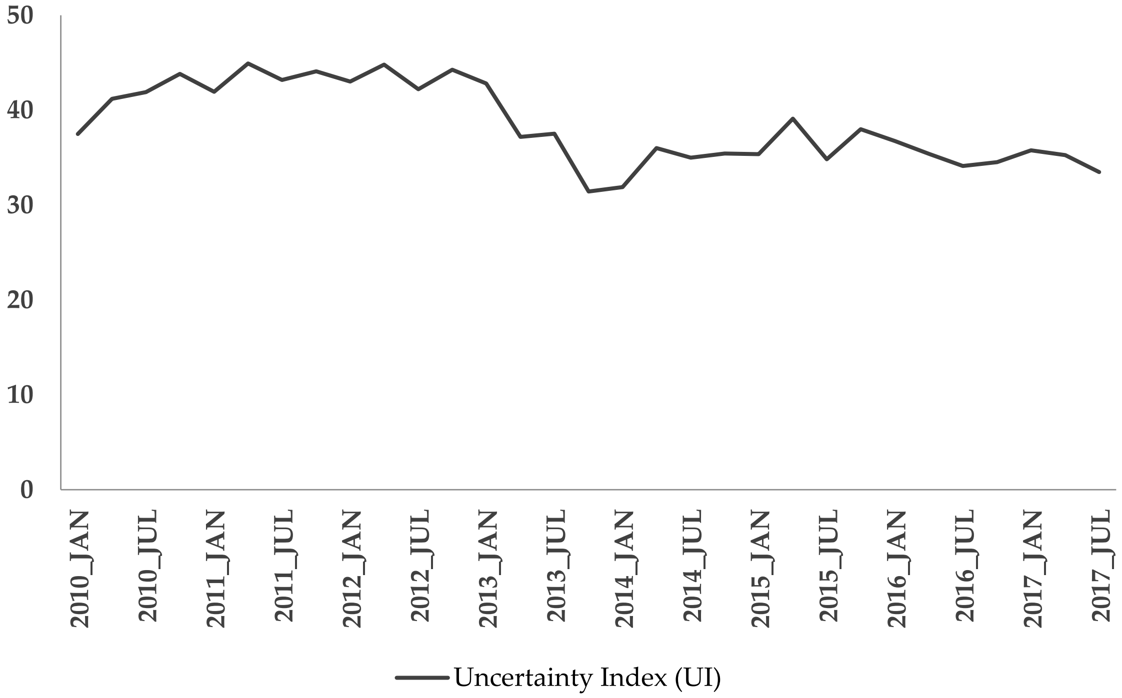


	Oct. 2016	Jan. 2017	Apr. 2017	Jul. 2017
Business Climate Index	30	31	21	**32**

Source: IEER 2017

The Uncertainty Index is currently at 33 points, a level slightly lower than in the previous quarter (it was 35 points in April 2017). This value of the Uncertainty Index indicates an increased uniformity in domestic businesses' evaluation of the current business climate. Since the start of the survey in 2010, the level of the Uncertainty Index has only been lower than it currently is on two occasions (in October 2013 and January 2014).

Figure 2: Quarterly developments in the Uncertainty Index, January 2010 – July 2017



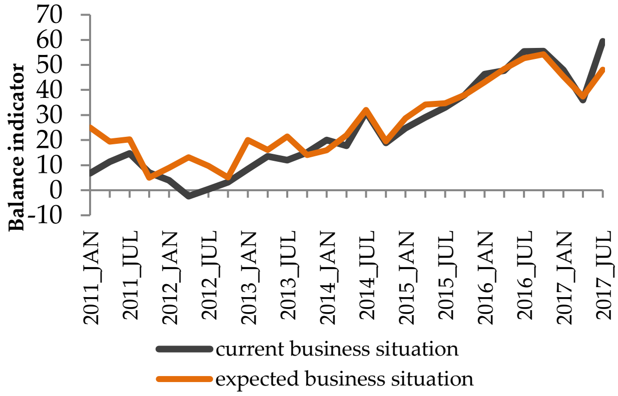
	Oct. 2016	Jan. 2017	Apr. 2017	Jul. 2017
Uncertainty Index	35	36	35	**33**

Source: IEER 2017

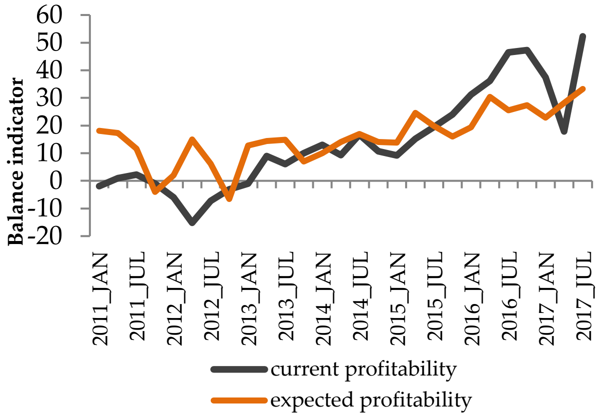
The IEER Quarterly Business Climate Index consists of ten components. The figures below demonstrate the quarterly developments of these.

Figure 3-8: Quarterly developments of the business climate indicators

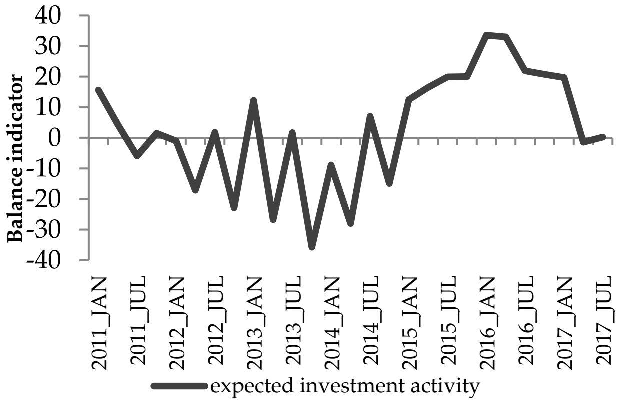
Current and expected business situation



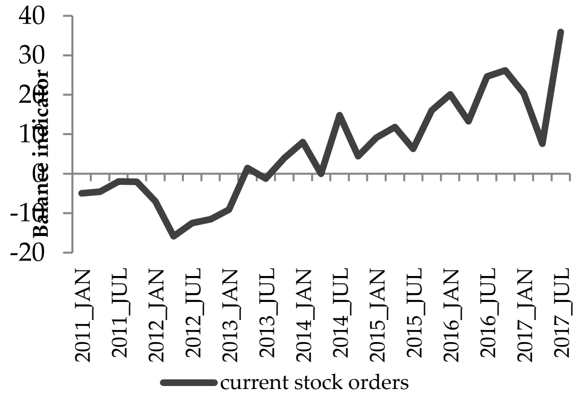
Current and expected profitability



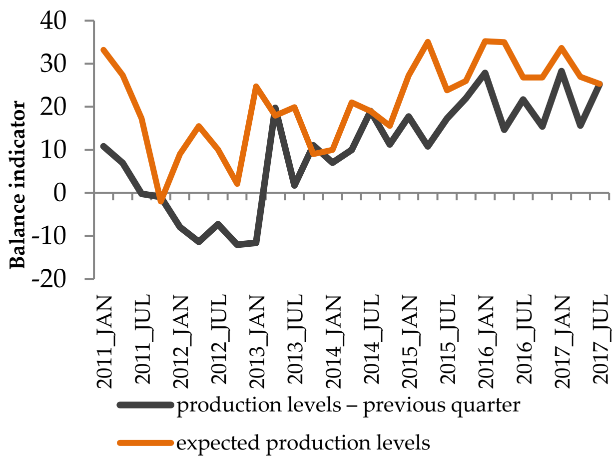
Expected investments



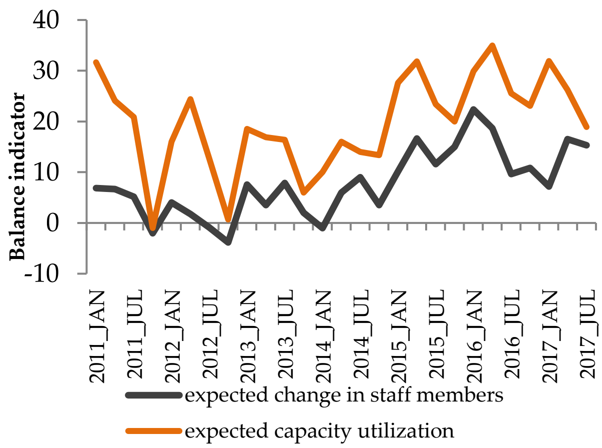
Current stock orders



Current and expected production levels



Expected change in staff members and capacity utilization



Source: IEER 2017

Donald Trump's planned financial deregulation

What consequences would the deregulation of the US financial system have?

This brief analysis aims to describe the deregulatory financial reforms proposed by Donald Trump's administration and its expected impact on the US and world economies. Curtailing the regulations governing the US financial system has been the flagship presidential campaign pledge and subsequently reform plan of President Trump, as he believes that US financial regulations are unnecessarily complex and stringent, and thus responsible for the relatively sluggish economic growth experienced by the country. However, the easing of the regulations implemented following the 2007-2008 financial crisis could have strong adverse impacts on the economy. This analysis critically examines the current regulations characterising the US financial system, the reform plan proposed by the Trump administration and the possible impacts of deregulation.

The current regulatory framework of the US financial system

The US financial system is currently regulated by the Dodd Frank Act, which was enacted following the financial crisis of 2007-2008. As the underregulated nature of the US financial system and the overreliance on large banks were among the root causes of the crisis, the primary aim of the Barack Obama administration after 2008 was to pass reforms to increase the stability of the financial system, and thus prevent the development of a similar financial crisis. As a result, the Dodd Frank Wall Street Reform and Consumer Protection Act was signed in July 2010, a comprehensive reform package that tightened the financial regulatory framework, and correspondingly greatly reduced the risks characterising the US financial system.

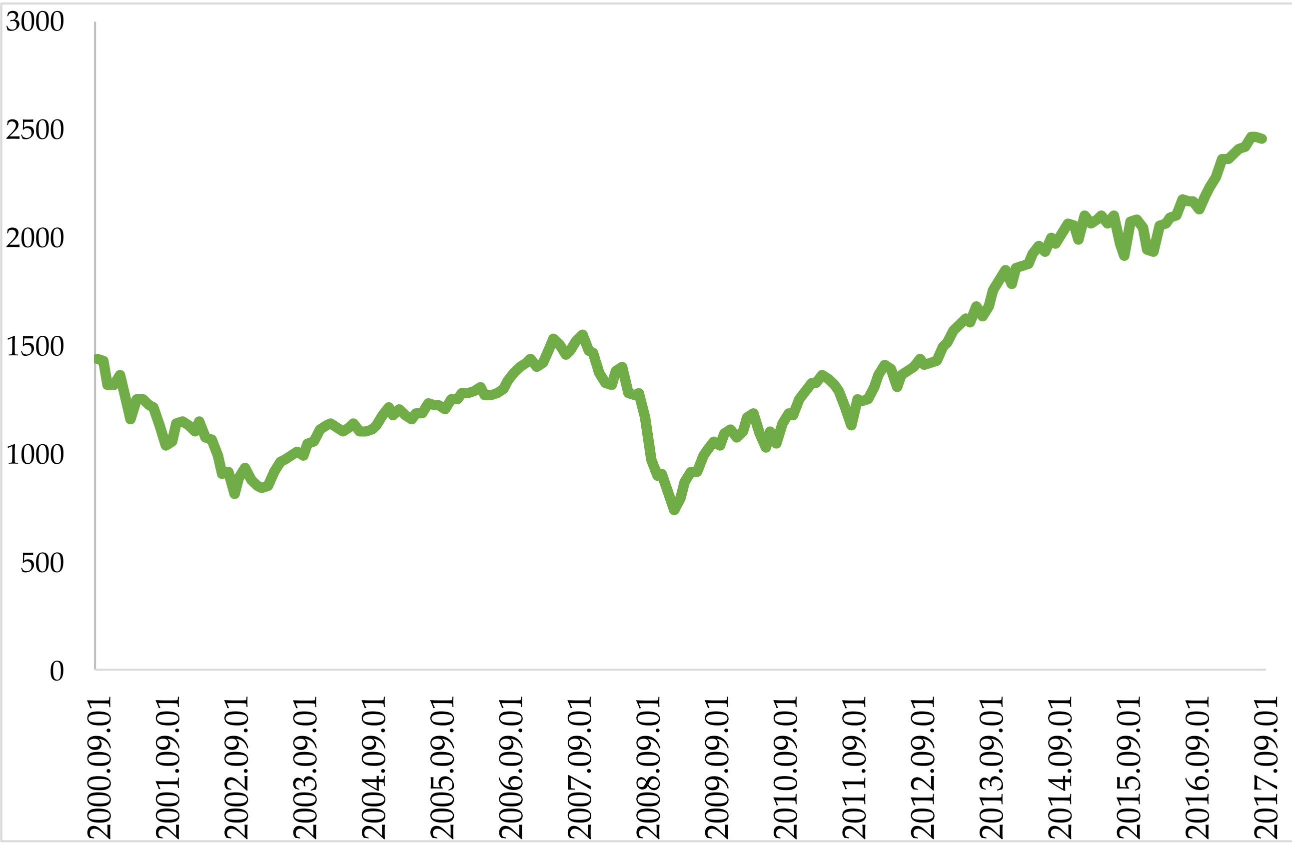
Figure 1: Real GDP growth rate, US and OECD countries, 2000-2016

Source: World Bank, https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2016&locations=US-OE&start=2000

The Dodd Frank Act encompassed the establishment of new, more stringent regulations and the creation of new government agencies that better scrutinised financial actors and their compliance with the tightened legislation. These newly established government agencies included the Financial Stability Oversight Council, which was tasked with monitoring the stability of both financial and non-financial large companies, the failure of which, due to their size, would have had adverse impacts on the US economy. To fulfil this function of identifying and responding to systemic risks, the Council's broad jurisdiction extends for instance to obligating large banks to increase their capital reserve.

As the financial crisis of 2007-2008 was triggered by excessive sub-prime mortgage lending and the resulting collapse of the sub-prime mortgage market, to prevent such occurrences, the Consumer Financial Protection Bureau was established as the main governmental agency responsible for consumer protection in the financial sector. It was tasked with preventing exploitative mortgage lending, increasing the accountability of companies engaged in mortgage lending, and promoting fairness and transparency in the financial sector by providing information to consumers on mortgages, credit cards and other consumer financial services and products.

Figure 2: S&P 500 Index, 1st September 2000 – 1st September 2017



Source: Yahoo Finance,
https://finance.yahoo.com/quote/%5EGSPC/history?period1=967586400&period2=1505080800&interval=1mo&filter=history&frequency=1mo

The Volcker Rule was also a flagship legislation of the Dodd Frank Act. It is a federal regulation that restrains banks' trading activities and compels them to separate their commercial and insurance functions, thereby limiting speculative trading and eliminating proprietary trading. Given the excessive risks related to involvement with hedge funds and private equity funds, the Volcker rule also drastically restrains banks' ownership of and relationship with such financial actors. Finally, the Dodd Frank Act also strengthened the regulations and transparency of the market for derivatives, enacting more stringent regulations on capital reserves and data provision requirements.

Created with the purpose of reducing the risk of another financial crisis, the Dodd Frank Act indeed had a stabilising effect on the US financial system and economy, as well as the world economy due to the interconnectedness of financial markets. The proponents of the Dodd Frank Act believe that its strengthened regulations have had predominantly positive consequences, which far outweigh the negligible costs of compliance with the requirements. They think the regulatory framework successfully reduced the likelihood of another financial crisis, as well as increased transparency and enabled better consumer protection. Yet, the numerous and complex regulations enacted have strengthened the US liquidity and capital requirements beyond international standards, and as a result, the Dodd Frank Act has evoked strong opposition from certain financial actors. Its opponents believe that compliance with the unnecessarily strict requirements on financial and non-financial companies reduce their competitiveness compared to their international counterparts, and thus greatly constrains American economic growth.

The deregulatory reform proposal

US President Donald Trump shares this view, and therefore issued an executive order for the review of the Dodd Frank Act on 3rd February this year. Soon after, the 'Financial CHOICE Act' was born, which, if enacted, would drastically cut back on the regulations currently governing the US financial system. This 600-page bill crafted by Republican congressman Jeb Hensarling recommends deregulatory reforms based on seven core principles. These are the ending of taxpayer bailouts of financial institutions, the assurance of the accountability of both Wall Street and Washington, the pursuance of simplicity rather than complexity, the revitalisation of the US economy, the assurance of financial independence for every American, consumer protection and the management of systemic risks via market mechanisms.

On these principles rest far-reaching, drastic reform plans. Firstly, the legislation would scrap the Financial Stability Oversight Council. It would also restructure and cut back on the power of the Consumer Financial Protection Bureau by allowing the president to fire its director, and extending Congress's jurisdiction to purview over its budget, enabling it even to defund the Bureau entirely. Moreover, it would also markedly reduce the number of stress tests that are performed to measure the risks relating to banks' activities. With relation to the mortgage market, it would enable smaller banks to increase lending by partially removing the strict regulations in place on lending costs. It would also ease the Volcker Rule, and allow banks to make speculative bets with their own capital. Finally, while as part of the Dodd Frank Act the Orderly Liquidation Authority enables the state to intervene if a bank is in the danger of failure, the Financial CHOICE Act would eliminate this power as well, and thus risk the occurrence of such events that could negatively impact the economy as a whole.

On 8th June, the House of Representatives passed the bill due to its Republican majority, but in its current form, the Financial CHOICE Act is expected to be rejected by the Senate. However, as financial deregulation is the centrepiece of President Trump's reform agenda, it is highly unlikely to be abandoned. It is presumed that the deregulatory reform proposal will be reworked until a form is reached that the Senate is willing to approve. If this happens, the deregulatory reform plans can be implemented.

The possible consequences of financial deregulation

The enactment of the reforms outlined above would have far-reaching economic consequences which are far from being perceived as exclusively positive. While in the short term it could have a positive impact on the competitiveness of American firms, in the long term it would greatly increase systemic risks to financial stability. The proponents of deregulation cite its positive impacts, such as increasing the profitability of companies, encouraging innovation and allowing for greater role for market mechanisms. These supporters of deregulation are prevalently large banks and companies, which could expect a marked rise in profit if the Financial CHOICE Act was implemented. According to estimates by Bloomberg[1], if this happened, the 6 largest American banks could see a rise of 22% in pre-tax profits, gaining a gross amount of $27 billion. Such large gains would result predominantly from the easing of regulation that would allow banks to buy US government bonds exclusively from borrowed money. Profit would also increase as with the new legislation, higher-yielding municipal bonds would be considered liquid assets, and capital requirements would also be lowered. Such changes would allow banks to make adjustments to the mix of securities they hold, and thus increase the interests earned on these assets. The greatest beneficiaries of the legislative changes would thus be JPMorgan, Bank of America Corp. and Wells Fargo & Co., but Citigroup Inc., Goldman Sachs and Morgan Stanley would greatly benefit as well.

Yet the opponents of deregulation believe that while the proposed reforms would indeed elicit a short-term increase in profit, its long-term negative consequences would easily outweigh such temporary gains. Firstly, it would considerably increase the risks of the development of another asset price bubble, which could trigger even a recession or crisis, as was the case in 2007. It

[1] https://www.bloomberg.com/news/articles/2017-08-23/big-u-s-banks-could-see-profit-jump-20-with-trump-deregulation

would also increase the likelihood of information asymmetries between sellers and consumers, fraud, and excessive risk-taking. Therefore, economists predominantly judge the proposed reforms negatively, warning that it would be harmful to the economy. Janet Yellen, Chair of the United States Federal Reserve System, the US central bank has also drawn attention to the dangers of deregulation. On the annual Jackson Hole policy conference of central bank chairs that was held between 24th-27th August, Yellen warned strongly against financial deregulation, stressing that the regulations enacted since the financial crisis has made the financial system more stable and secure without unduly hurting US economic growth. She also highlighted that there is no conclusive evidence on regulation reducing the availability of credit, while a financial crisis would certainly have this effect. She also strongly advised against overconfidence, stressing that it is crucial not to forget the lessons from the financial crisis that started 10 years ago. However, she did agree with the US President in that some reforms aimed at simplifying regulation could be sensible, but exclusively if they were carried out in a well thought-out, cautious way.

Conclusion

Donald Trump's financial reform plan is a highly contentious topic in current economic discussion. While large banks and companies support the proposed financial deregulation, and see it as a great chance for revitalising the American economy and increasing economic growth, the majority of economists disagree. While they would welcome a deliberated, prudent simplification of the at times indeed overly complex financial regulations, they believe that hurried and drastic financial deregulation can have grievous economic consequences. Despite such warnings however, the Trump administration is highly unlikely to abandon its aim of radical financial deregulation. The success of deregulatory reform depends on securing congressional support for a new, reworked legislative proposal.

International trends

Development of production, consumption and employment in certain globally significant economies, compared with expectations and values of the previous period.

		Period in review	Actual data	Expectations	Previous period
Germany	Unemployment Rate	(Aug)	**5.7%**	5.7%	5.7%
	Manufacturing Purchasing Managers Index	(Aug)	**59.3**	59.4	59.4
	IFO Business Climate Index[1]	(Aug)	**115.9**	115.5	116.0
France	INSEE Business Climate Index[2]	(Aug)	**109**		108
USA	Unemployment Rate	(Aug)	**4.4%**	4.3%	4.3%
	CB Consumer Confidence Index	(Aug)	**121.1**	116.5	117.3
	Manufacturing Purchasing Managers Index	(Aug)	**52.8**	52.5	52.5
China	Manufacturing Purchasing Managers Index	(Aug)	**51.7**	51.3	51.4

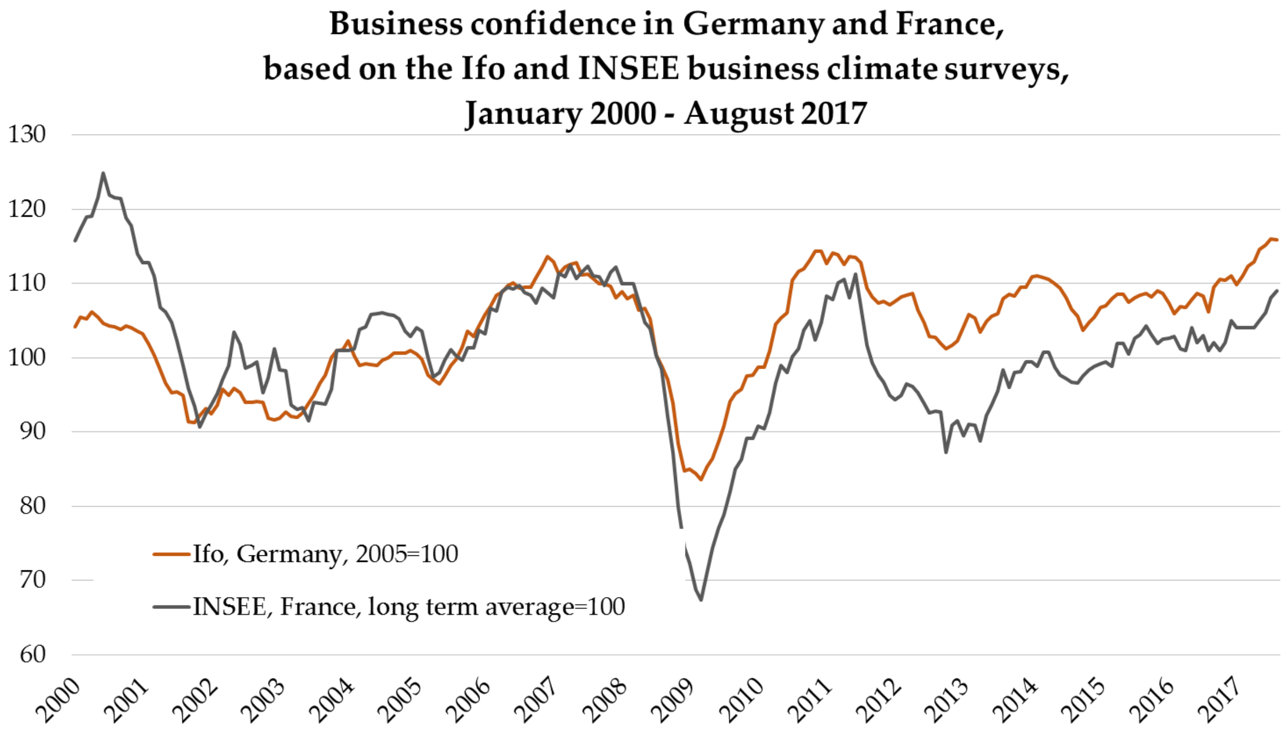
https://www.cesifo-group.de/ifoHome/facts/Survey-Results/Business-Climate/

[2] http://www.insee.fr/en/themes/indicateur.asp?id=105

Source of the remaining data: http://worldeconomiccalendar.com

The performance of the German economy has not changed significantly in August compared to the last months. The level of unemployment stagnates around the 6 percent rate and has not changed compared to July. The manufacturing purchasing manager index (PMI) has decreased slightly compared to the previous month and the expectations. After several months of increase the IFO business climate index shows a slight decline but remains at a high level compared to previous periods. The French INSEE business climate index has continued to improve compared to the previous month. In the United States the CB consumer confidence index was higher than in the last month and the expectations. The manufacturing PMI shows a slight increase as well. The level of unemployment, however, was higher than the expectations and the rate of last month. The Chinese manufacturing PMI, after a decrease in the last month, performed again significantly better than the expectations.

Long-term changes in business confidence indices



Source: www.cesifo.de, www.insee.fr

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