To prevent this fresh wave of liquidity from flooding and stagnating on the banks’ balance sheets, the ECB began penalizing the deposits the banks held on its own books, applying an interest rate of 0.1 percent.

In September, the ECB went a step further. The basic interest rate (MRO – maintenance, repair, operations) for bank loans was trimmed once again, this time to 0.05 percent (in other words, virtually free money), while the interest penalties banks faced for depositing funds at the ECB were hiked to 0.2 percent.

But even that was not enough. The ECB also decided to try out a new kind of expansive policy, aimed not only at providing liquidity to the banks but also ensuring that they used their newfound resources to plough much needed credit into the “productive” real economy, by expressly forbidding mortgage loans and public sector lending. To do that, it would provide long-term credit lines to the banks, at a slightly higher interest rate than shorter term loans. However, the gap would narrow over time. Once again, as-good-as-free money – just over a longer time frame.

It was not the first time that the ECB had opened up long term credit lines to the banks. It had already done it on two previous occasions: once, at the tail end of 2011, and the other at the beginning of 2012, through the LTRO (long-term refinancing operations). However, in this new format the ECB had effectively announced a whole new program of quarterly issuance windows, from September 2014 to December 2016, with the special provision that the banks would be forced to pay back the credit before schedule if its loans to the “productive” sector did not reach a level deemed “desirable” by the ECB. In effect, it amounts to one huge monetary experiment, via the LTRO, that is wholly lacking in terms of historical precedents and whose operational effectiveness raises so many doubts at so many levels that even the banks have been reluctant to sign along the dotted line, regardless of how favorable the conditions may be.

To round off the liquidity rush, the ECB last year launched the first tentative stages of its “ABSP” (asset backed securities program) and “CBPP3” (covered bonds purchases program).

But it was still not enough. The incessant calls for the ECB to undertake clearer, more effective lines of action, through direct intervention in the markets, culminated on January 22 in the ECB’s announcement that it would buy debt securities directly from the market, including those issued by governments and European agencies and institutions. The purchase of government bonds will
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Whatever its detractors may say, the ECB has more than fulfilled its obligations: it has responded to the market’s demands and has just about exhausted its monetary policy options.

Potential European growth is seriously threatened by a series of structural obstacles. Although there is practical unanimity when it comes to identifying them, an enormous divergence of opinions emerges whenever talk turns to the issue of appropriate reforms for overcoming them.

be proportional to each country’s holdings of ECB capital (see Table). The program will involve monthly acquisitions amounting to some 60 billion euros of debt securities up to September 2016; in other words, a total outlay of 1.2 trillion euros – more or less the equivalent, at least in volume terms, of the “quantitative easing” (QE) program recently completed by the U.S. Federal Reserve. What distinguishes the European program is that the risks are shared between the ECB itself (20 percent) and each of the euro-system’s central banks. In other words, it is a woefully small step toward the mutualization of sovereign debt needed in a genuine European Monetary Union (EMU).

Whatever its detractors may say, the ECB has more than fulfilled its obligations: it has responded to the market’s demands and has just about exhausted its monetary policy options. Its expansive policy not only helps boost internal demand; it should also exert downward pressure on the euro’s exchange rate, thus bolstering overseas net demand.

The trillion euro question is: what more can be done to strengthen Europe’s economic recovery and who needs to do it?

If the EZ’s economic growth depended solely on expanding aggregate demand, there would be practically nothing left to do. The only alternative available – fiscal policy – has very little room for maneuver in a monetary area such as the eurozone, where the collective budget deficit is precariously close to 3 percent of GDP. One thing that still remains to be done is to redistribute the budgetary balances so that the inevitable fiscal tightening in countries like Spain and France is counterbalanced by a more expansive fiscal policy in core economies like Germany. That said, a widening of the budgetary gap, which would ultimately limit the scope for further action in the fiscal terrain, seems to be an unreasonable proposition.

There is, however, plenty that can still be done on the supply side, where opposition to change remains fierce, and not only on the European Union’s periphery but also at its core. Potential European growth is seriously threatened by a series of structural obstacles. Although there is practical unanimity when it comes to identifying them, an enormous divergence of opinions emerges whenever talk turns to the issue of appropriate reforms for overcoming them. Below we discuss four of the main obstacles hindering European growth:

1. Europe’s crippling demographics. The old continent’s active population is in slow decline, a result of its low birthrate and the gradual aging of its population. According
to United Nations forecasts, by the year 2050, people over 65 will account for 40 percent of the population.

2. The excessive weight of a bloated public sector, whose total spending represents 49.5 percent of European GDP (57.9 percent in France). This spending is not focused on productive activities, but rather on wealth transfers needed to support the so-called “welfare state” whose funding rests on much higher fiscal pressures than those of other advanced economies. This inhibits investments in vital areas of the productive economy. Given this backdrop, the fact that France continues to resist any meaningful reform and Germany has decided to lower the retirement age (!) shows how little hope there is of real change at the heart of the EU, never mind the periphery.

3. The continued existence of significant rigidities in Europe’s goods and (more importantly) services markets. The directives aimed at addressing this problem are not, it seems, being applied equitably in all EZ Member States. Large (and unequal) rigidities also plague the labor markets, making it much more difficult to create new jobs. Even Germany, which over the last decade has led Europe’s reform efforts, with excellent results, has taken a step backward in key policy areas, such as in its reestablishment and increase of the youth minimum wage and changes in the termination of contracts legislation.

4. Lastly, the trends toward nationalism and interventionism in the eurozone’s economy. France takes the honors in this regard, but some recent decisions in Germany (such as the closure of nuclear plants and its opposition to a common energy policy) give little hope for reformist leadership.

Throw in the fact that Europe suffers from weak governance at the regional level (albeit with significant advances in the financial and banking areas), as well as rampant mistrust regarding the mere idea of mutualizing fiscal policies, means that the European train is advancing on just one side of the tracks. Does a common monetary policy represent the absolute limit of our capabilities?

Clearly, Europe does not lack the means to straighten out its current situation. Lest we forget, it is one of the world’s strongest economic regions, with a huge pool of physical and technological capital. The region was once the cradle of the Industrial Revolution, where the cultivation of science and vast R&D investments helped change the face of the world. Europe also boasts a strong labor force that enjoys the benefits of one of the world’s best performing educational systems. Finally, it possesses enviable levels of institutional capital, perhaps not so much at the regional level, but certainly in each of the countries that make up the EU, where democratic stability, the rule of law and the transparency of governmental decisions (all unquestioned) help create fertile ground for a solid investment environment.

The world boasts few economic regions that can offer such rich and varied capital. It’s “just” a question of organizing it all within a framework of greater economic freedom.

Juan José Toribio. Professor of Economics, IESE Business School

The Swiss Turmoil

On January 15, the Swiss franc (SFr) experienced one of the sharpest appreciations in recent history.

It surged as much as 39 percent against both the euro and the dollar after the Swiss Central Bank unexpectedly abandoned the ceiling of 1.2 SFr per € it had self-imposed three years ago and had reaffirmed only three days before. The shock was such that several foreign currency traders were forced out of business.

What Is a Currency Ceiling?

In 2011, financial markets around the world were collapsing. The problem was especially serious in the eurozone where concerns about the potential disintegration of the euro, bank failures and sovereign defaults were flooding the market. In response, panicked investors
The increasing accumulation of euros needed to keep the franc relatively cheap has led to a significant enlargement of the SNB’s balance, which now is more than 80 percent of the Swiss GDP.

The SNB reacted by pegging the franc against the euro, committing to buy as many euros as necessary while selling its own currency to keep the euro above 1.2 SFr. This move led to a substantial increase on the euro reserves in the hands of the SNB (Graph 1).

Why Did the SNB Unpeg It?

Switzerland is a very open economy which, just before breaking with the peg, was already facing very low inflation (close to zero) and low consumption. Abandoning the peg would very likely take it to the verge of recession. Why, then, did the SNB decide to stop it? Here are some of the possible arguments.

First, the increasing accumulation of euros needed to keep the franc relatively cheap has led to a significant enlargement of the SNB’s balance, which now is more than 80 percent of the Swiss GDP. This percentage is about three times higher than that of the U.S. Fed and the Bank of England. This fact has led many to argue that the Swiss franc cap was unsustainable. This is clearly true when a central bank is trying to keep the value of its currency high, hence having to buy its own currency while getting rid of foreign reserves. Once it runs out of foreign currency to sell, the peg fails. However, the case of the franc was just the opposite one, and so it could have been sustainable for a longer period. However, the SNB was facing increasing political pressures about its balance size. In November, there was an unsuccessful referendum attempting to force the SNB to increase the proportion of its reserves in gold.

Second, there are concerns about hyperinflation. So much printing will eventually lead to higher prices, many argue. However, when one looks at what is currently happening in Switzerland, the situation is just the opposite.

Third, the SNB reacted in anticipation of the expected introduction of “quantitative easing” by the European Central Bank (ECB). Markets were expecting the ECB to launch a bond-buying program financed by money creation just one week after the surprise Swiss announcement. Such a program would dampen the value of the euro, forcing the SNB to buy even more euros and print even more national currency to maintain the peg.

All these factors are likely to have contributed to the Swiss abandonment of the peg, however, none of them seemed to be a pressing enough issue to justify such a sudden move. The extent of the market reaction indicates that investors had not even bothered to guard against it.

What Have Been the Implications?

Switzerland will now have to face several important problems. First, after the sharp appreciation of the franc, Swiss exporters will confront stronger competitiveness challenges. Second, it might heighten the risk of Swiss deflation. Imports will now be cheaper, which may intensify pressure to lower Swiss inflation (it was -0.3%). This, in turn, might further depress already weak consumption. Third,
On the verge of greater central bank volatility, investors have turned to gold, triggering a gold rally.

Fourth, the SNB’s abandonment of the euro peg has had unintended consequences for some Central and Eastern economies. In some countries, such as in Poland and Hungary, it was not unusual for people to borrow in Swiss francs and take advantage of lower Swiss interest rates. This worked beautifully until the franc appreciated, making it much more difficult for the borrowers to pay back their loans. Fifth, on the verge of greater central bank volatility, investors have turned to gold, triggering a gold rally with its value reaching a four-month high.

Final Remarks

This unanticipated change is, in some sense, positive: a distortion has been removed from the market. However, the full consequences of such a sudden move are still unknown. If nothing else, the Swiss action highlights the difficulties that smaller banks face when navigating the difficult situation of the ECB loosening its monetary policy and the U.S. Fed tightening it. Finally, it could have contagion effects and probably many investors are already now looking much more closely at the Danish peg with the euro.

Núria Mas. Professor of Economics,
IESE Business School

A Point in Favor of Less Efficient Prices

We live in volatile times. In the past couple of months, the value of the US dollar doubled relative to the Russian ruble. On one day in January, the Swiss franc appreciated against the euro by roughly 30 percent, within minutes. The commodity markets also have seen their share of volatility. Crude oil prices dropped from $85 a barrel to below $45 and have since recovered somewhat.

In light of all this volatility, one may ask to which degree prices are informationally efficient in the sense of being representative of the expected fundamental value\(^1\) of the underlying asset, given all available information, in a given moment in time. More specifically, were oil prices informationally efficient at $85 dollars a barrel four months ago, or that is, prior to dropping by roughly 50 percent? Going back a little further, were prices of new economy and technology stocks accurately representing the aggregate information of market participants in March 2000, prior to the NASDAQ index losing over 75 percent of its value over the following 18 months?

The Long Debate on Informationally Efficient Prices

The general question of the information value of prices has long held center stage in economics and has been debated among its most brilliant minds.

\(^1\) The fundamental value of an asset refers to the value derived from fundamental analysis not market analysis. The fundamental value of a stock would be the discounted sum of future cash flows.
brilliant minds. This question gained prominence thanks to John Maynard Keynes and Nobel Laureate Friedrich August von Hayek. In “The General Theory of Employment, Interest and Money” (1936), Keynes argues that the behavior of rational stock market participants is similar to the behavior of judges in a beauty contest who care more about picking a winner than having the most beautiful girl win. In a stock market, this would imply that portfolio decisions are based not on one’s own estimate of fundamental values, but on the estimate of the market’s estimate of fundamental values. Therefore, market prices might fail to incorporate substantial amounts of private information. Hayek, on the other hand, was a believer in informationally efficient prices. The members of a society hold a tremendous amount of information in the aggregate. But at the same time, each member might have bits and pieces of information that unfolds its value only in combination with other pieces of information which might be known only to other members of society. The main insight of his seminal paper, “The Use of Knowledge in Society” (1945), is that prices play a fundamental role in aggregating the dispersed private information held in a society.

Shiller’s theory of “irrational exuberance” concludes that prices deviate from fundamental values given the aggregate information due to irrational behavior by market participants. At first glance, it seems to be highly desirable for prices to perfectly aggregate all dispersed private information. But is this always true?

Efficient Market Hypothesis at work because the price shock followed an unexpected announcement of the Swiss National Bank to discontinue its currency ceiling relative to the euro. Within minutes, this unanticipated event was priced in the market exchange rate. On the other hand, whether or not the NASDAQ index fully represented all private information in March 2000 is difficult to determine, to say the least.

Shiller’s theory of “irrational exuberance” concludes that prices deviate from fundamental values given the aggregate information due to irrational behavior by market participants. In December 1996, Shiller argued, based on his theories, that stock prices had reached irrational levels, only to witness the NASDAQ index quadruple in the subsequent four years. While he was right that the market was on a path to reaching irrational levels, his timing was well off. Had he been trading based upon his theory, he almost certainly would have gone down in flames. But Shiller, being an academic and not an investor, avoided the inconvenient consequences from trading with bad market timing. He might have just followed the words of wisdom John Maynard Keynes spoke many decades before: “The market can stay irrational longer than you can stay solvent.”

Years later, in 2005, Robert Shiller again received attention from the mainstream media by stating that the US was experiencing an unprecedented housing bubble on its way to an unprecedented housing bust. His reasoning was based on a chart of US real home prices just as the one displayed in figure 1.

This time, however, Shiller was right and his timing off by only one year. At the time of
his warnings, a by-then unknown merger arbitrage hedge fund manager, John Paulson, began buying insurance on residential mortgage-backed securities which would yield payments only if the underlying securities default. His epiphany of betting the house against housing was triggered by the exact chart of figure 1. His trade made history as the “greatest trade ever.”

The debate so far mainly focused on the degree to which prices aggregate information. At first glance, it seems to be highly desirable for prices to perfectly aggregate all dispersed private information. But is this always true?

Are Informationally Efficient Prices Optimal?

To answer this question, imagine a market with two competing goods, both with unknown fundamental value and unlimited supply. New information regarding the fundamentals arrives over time such that, in the long run, the value of fundamentals is revealed.

Suppose that the prices of both goods are efficient, that is, they aggregate all current information and hence the price of each product equals its expected fundamental value given the available information. But this implies that, absent new information, the market participants are indifferent between buying either good. What drives demand to either good is the arrival of new information.

Suppose instead that prices are not efficient and that the market has an informational advantage not incorporated in current prices. This implies that, absent new information, one good is superior to the other in terms of net expected value, taking the purchase price into account. This is a useful observation when considering how to optimize the overall welfare in this market. The higher the number of purchases of the good with superior fundamental value, the higher is the overall welfare. So in order to maximize welfare, one would want to drive demand to the superior good but, of course, the fundamental values are not known with certainty.

In the paper “Market Power, Fully Revealing Prices and Welfare”\(^3\), I analyze the relationship between informationally efficient prices and welfare in a standard dynamic market model. In particular, I ask how the frequency with which prices are reset efficiently according to the current information affects the overall welfare in the market\(^4\). The main result is quite surprising.

Welfare decreases in the frequency with which prices are reset according to the available information. In other words, welfare is increasing during the time that the market has an informational advantage over the price. Here, the informational advantage makes the good that has higher expected fundamental value preferable, taking into account the prices of both goods. So demand is driven to the good that is considered superior based on the current information. But, of course, the fundamental values are not known with certainty and the good currently perceived as superior might in fact be the one with lower fundamental value. However, the arrival of new information over time assures that in the long run the good with higher fundamental value will be superior in net terms, subtracting the price.

Bringing this argument to its logical conclusion, fixed price regimes where no new information is ever incorporated in the price might lead to higher welfare than an efficient pricing regime where, in the long run, prices are equal to fundamental values. In context of the debate on informationally efficient prices, my conclusion can be summarized by “be careful what you wish for.”

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\(^2\) Mortgage-backed securities are financial securities that hold claims on the cash flows generated by a large pool of individual mortgages.


\(^4\) In the model, prices are recalculated according to the available information only at certain moments in time, while new information arrives continuously. If new information comes to light and the price is not instantly adjusted to this new information, then the market has an informational advantage.

Manuel Mueller-Frank. Professor of Economics, IESE Business School
Innovation as Usual: How to Help People Bring Good Ideas to Life

Tokyo, February 26
Prof. Paddy Miller

Paddy Miller is professor of Managing People in Organizations at IESE. His interests lie in the area of leadership and the management of change and recently have focused on the specific issues of leading innovation in multinational organizations. Dr. Miller’s particular approach to innovation has been to take a longitudinal perspective to organizational transition as innovation is embedded in the culture. In line with this view, he has become extensively involved in management development issues in many organizations during the transition to being creative organizations. His work has culminated in a new book Innovation as Usual, published by Harvard Business Review Publishing in 2013, co-authored with a colleague, Thomas Wedell-Wedellsborg.

How to Make Your LinkedIn Profile Key to Your Success

London, February 27
Prof. Mike Rosenberg

On this occasion, we will have the opportunity to learn more on the new trends in career management and rediscover the social network that has shaken up the way professionals are hired. We will look at how LinkedIn plans to create the world’s first global economic map; how to optimize and improve your profile to stand out from the crowd; and which tools and techniques the best recruiters use to identify talent. The session will be addressed by IESE Professor Mike Rosenberg and three LinkedIn Senior Managers.

Global Criminal Networks

Brussels, March 5
Prof. Antonino Vaccaro

How do criminal organizations affect the economy? And how is the activity of a “normal firm” affected by criminal networks? Are criminal organizations local or global? What are the sectors that are more attractive for criminal networks? And what is the total amount of mafias’ revenues around the world? How is it possible to prevent and fight the infiltration of criminal networks in your organization? This session will try to address these questions through the discussion of data and examples resulting from recent research projects conducted within the Center for Business in Society of IESE Business School and some consultancy experiences of the speaker.

Corporate Risk Management for the SME

Barcelona, March 10
Prof. Markus Maedler

How can increasingly decentralized, global, and complex organizations govern and manage their risk-taking to achieve superior and sustainable value? Update yourself about latest research, best practices and critical trends.

Personal Financial Planning

Paris, March 12
Prof. Ahmad Rahnema

Money is not the most important thing in life. It is not an end in itself. Focus too much on money and you will surely miss the true meaning of your life. Money is not even our main material need; health is more important. However, we need some money to support our life. Life with little money or health may be quite uncomfortable indeed. We seem to be much better prepared at taking care of our health than our money. This is hardly surprising. Neither our schools nor our universities offer courses on personal finance. The fact is that nobody really cares about your financial education.

Add to this the existing perception that financial planning is a really onerous and complex process and it is no wonder that many people are scared off. Certainly, there are many players with massive hidden agendas that would have us believe that financial planning is incredibly complex and that you need significant funds and complicated models to do it. However, as the title suggests, this session aims to debunk the myth that financial planning is only for the wealthy and super intelligent! Everyone should have a financial plan.

FOCUSED PROGRAMS

Develop Your Communication Skills: It’s How You Tell Them

Barcelona, April 21-28

Discover how to speak powerfully and communicate effectively in a variety of contexts, capture the attention of your audience and make your body language work to your advantage. Clear and powerful communication is vital for accomplishing any business objective, particularly in today’s economic climate. To be effective, executives must be able to engage and influence diverse stakeholders, including clients, colleagues, employees and top management.

Getting Things Done

Barcelona, May 11-14

When a business strategy fails, shortcomings are often exposed – not necessarily in the strategy itself – but in its execution. The ability to get things done is critical for business leaders and it is the overriding factor in determining a company’s long-term success.

This program features the expertise of IESE Professors Fabrizio Ferraro (Academic Director), Antonio Dávila and Marco Tortoriello, as well as the vast experience of Stanford University Professor Jeffrey Pfeffer, a world-renowned expert on management, leadership and human resources.

The International Economic Overview is also available online, in Spanish as well as English. Access the publication at www.iese.edu/alumni/coyunturaeconomica