

Macroeconomic imbalances in a low-inflation era

Raul Sampognaro (OFCE)

Session: Unemployment as the major macroeconomic challenge

TUREC

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iAGS report - 2016
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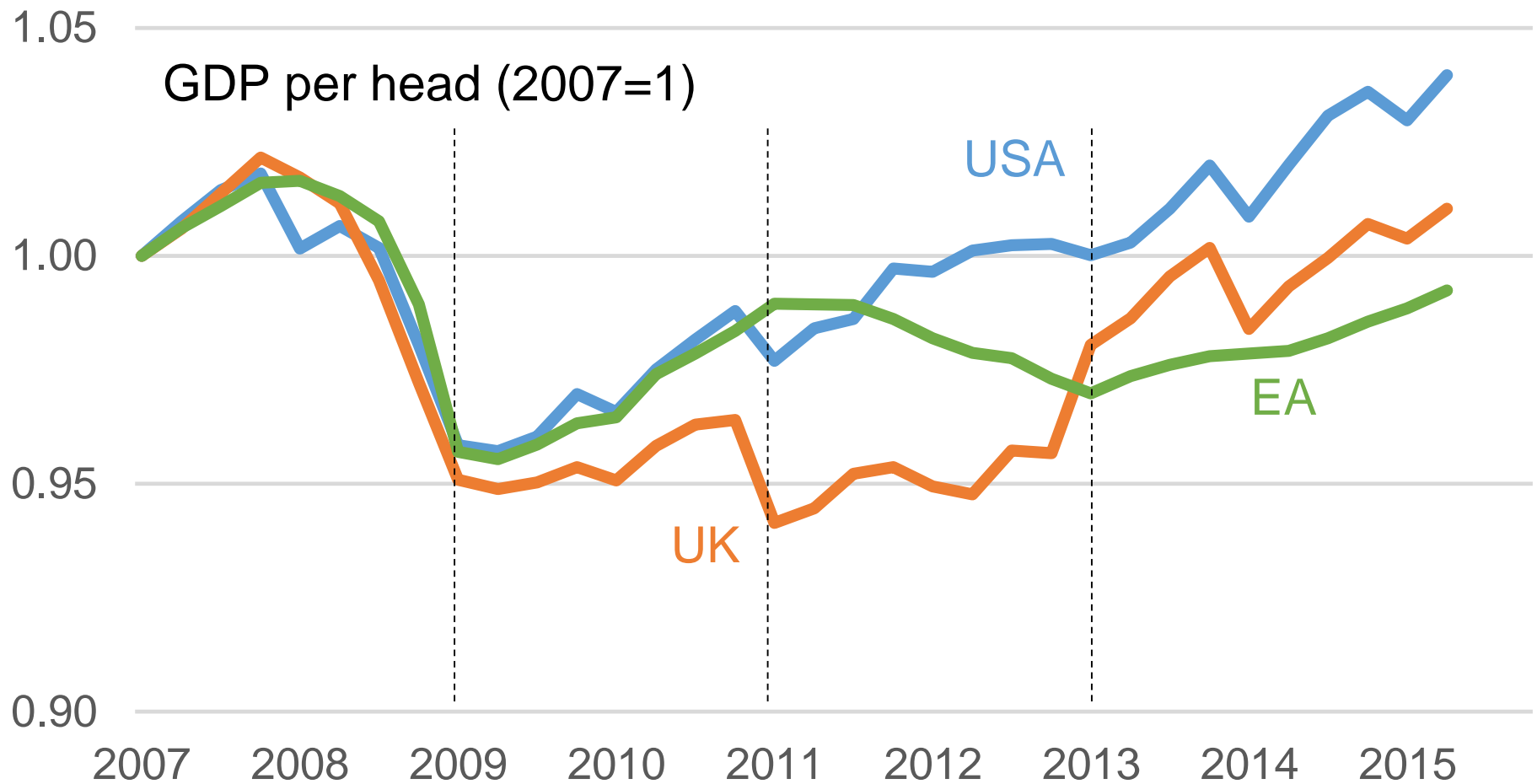


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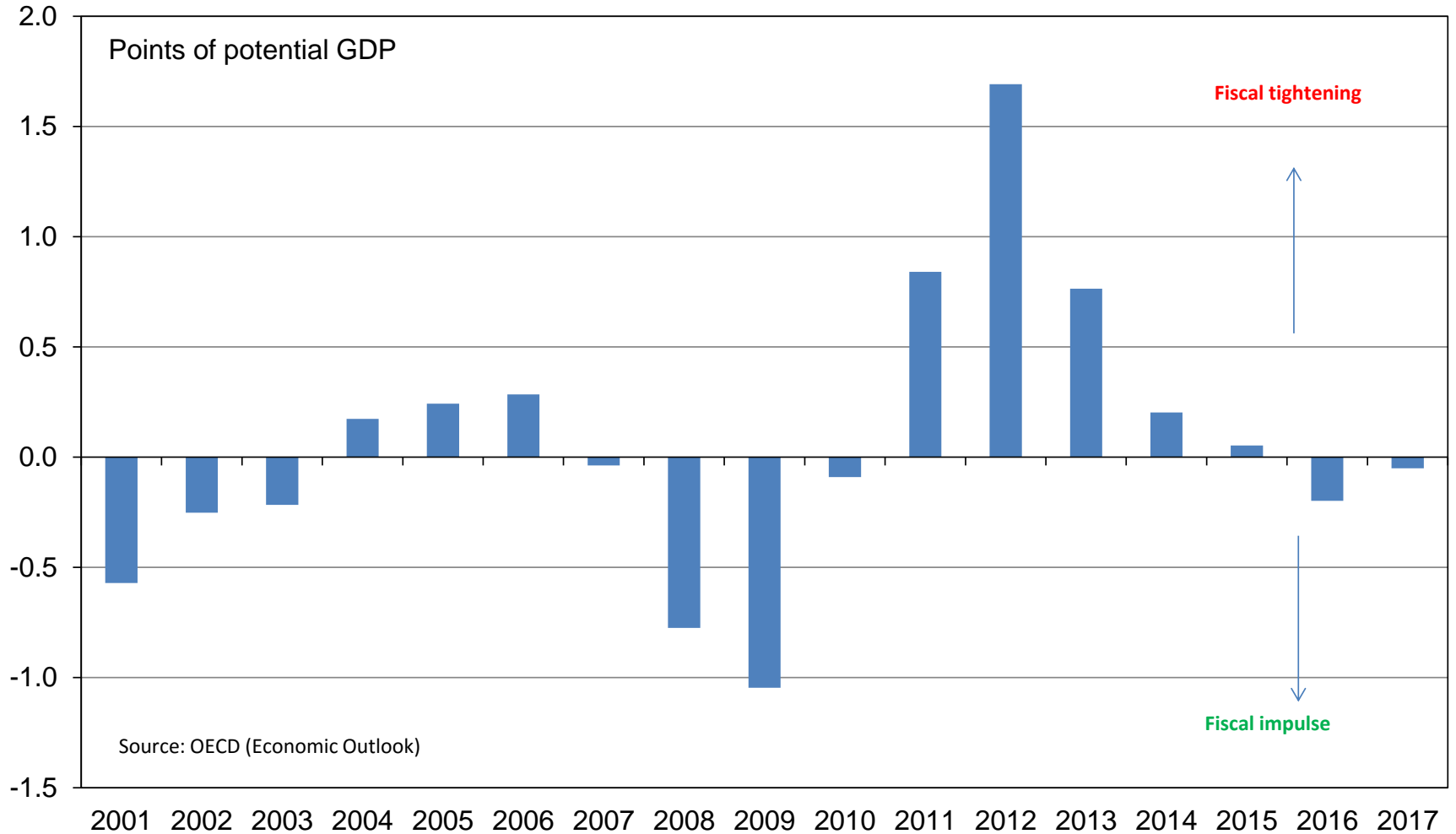


1) Where do we come from?

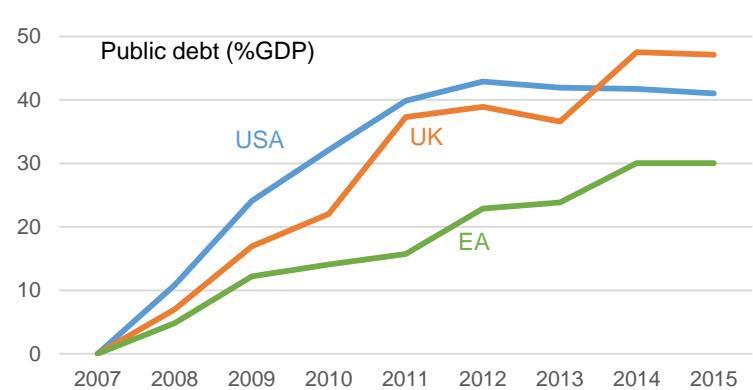
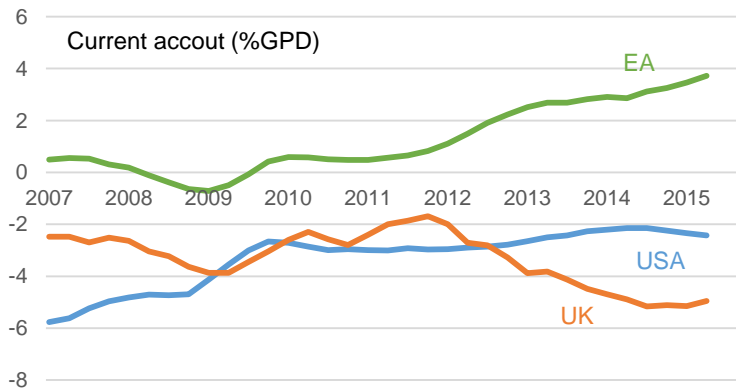
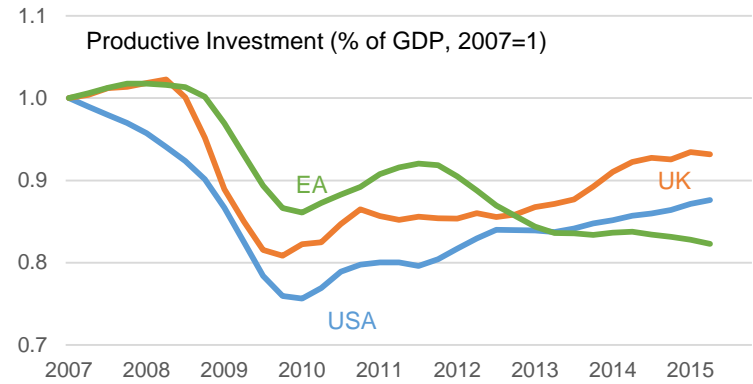
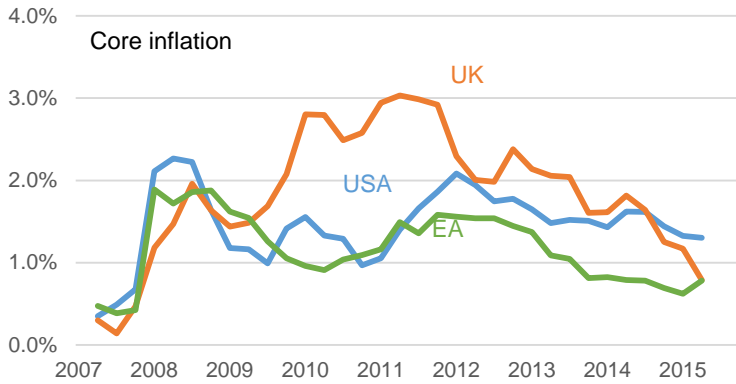
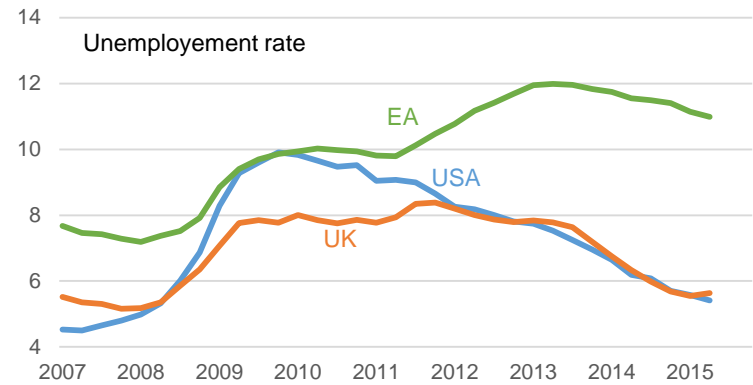
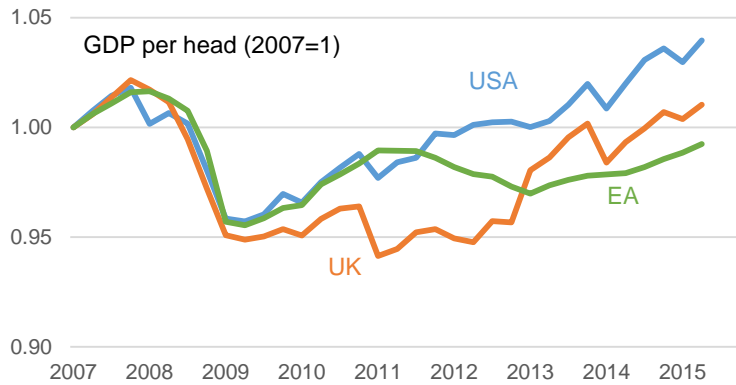
The EA since the start of the « Great Recession »



Euro Area: evolution of the structural balance

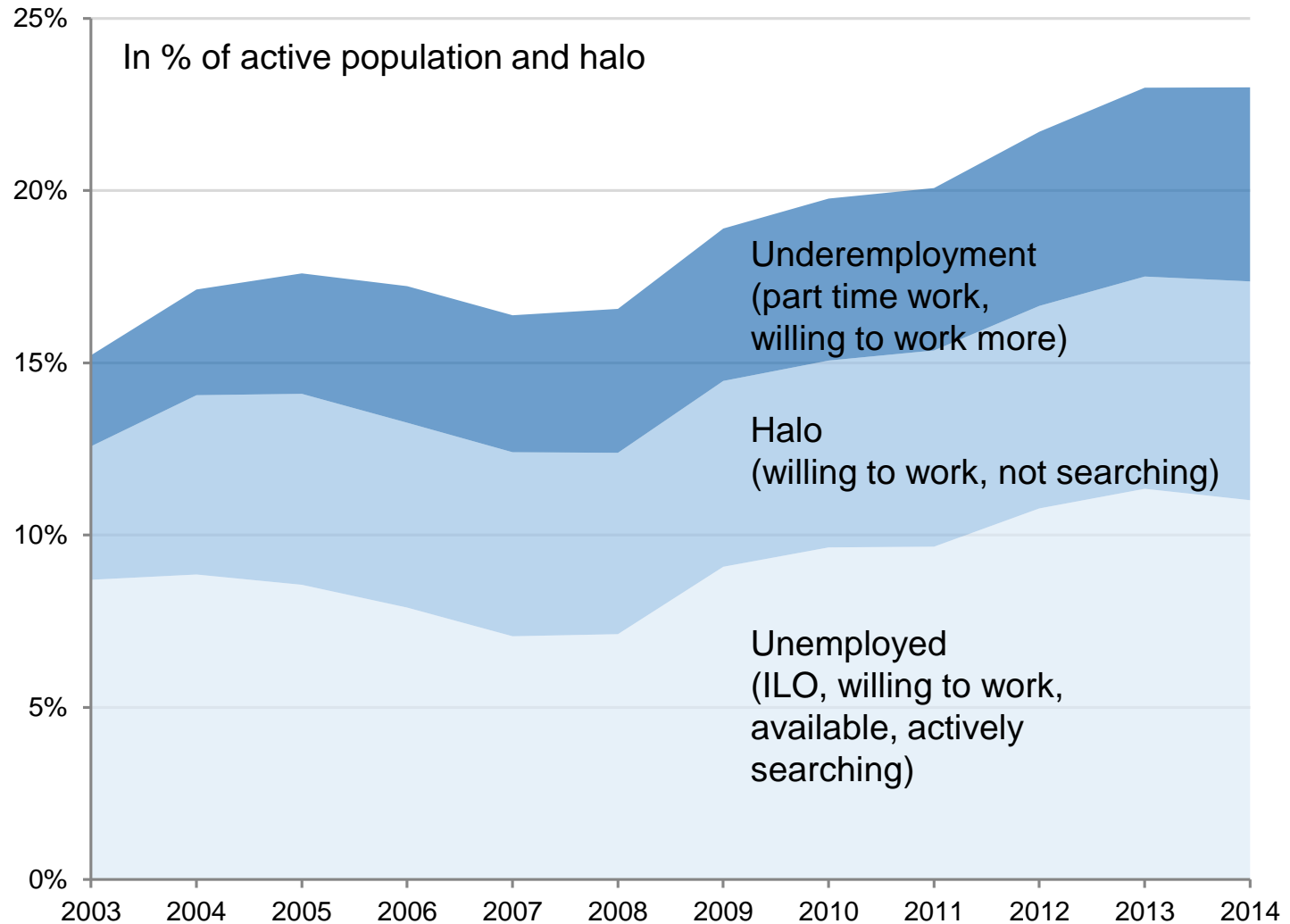


Euro Area: success and failure



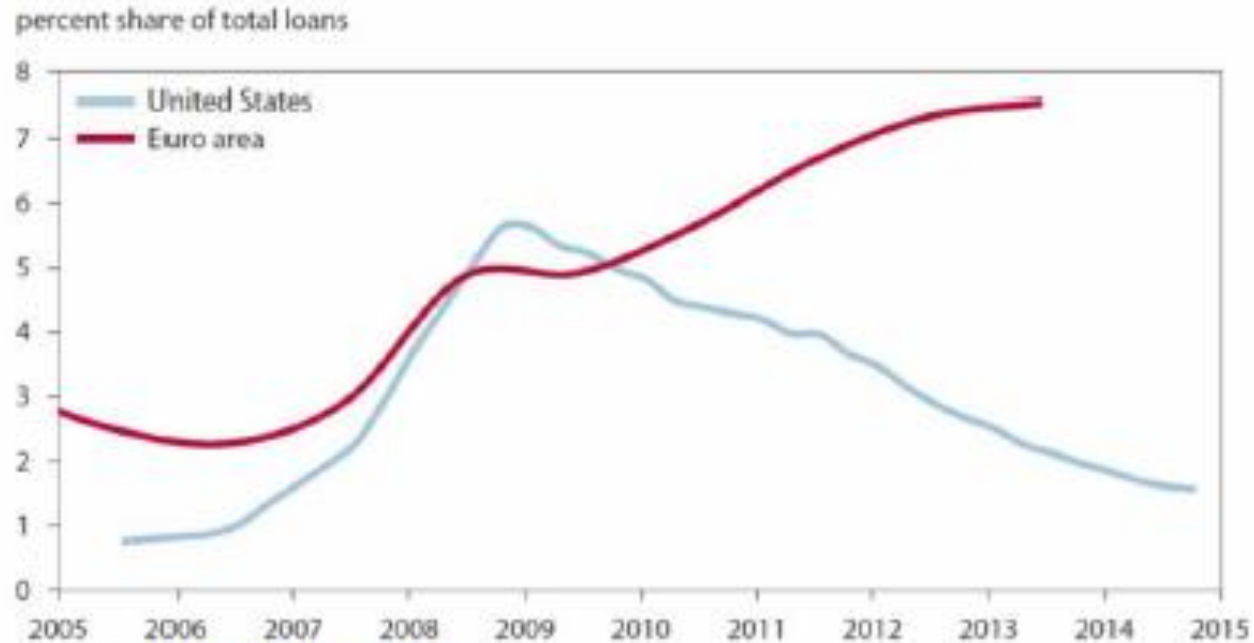
2) Where do we stand?

Imbalance #1 : Labor market slack and social consequences



Imbalance #2 : Fragile banking system

Figure 1: The evolution of NPL ratios in Europe and in the US



Source: [PIIE](#), 2016, p24

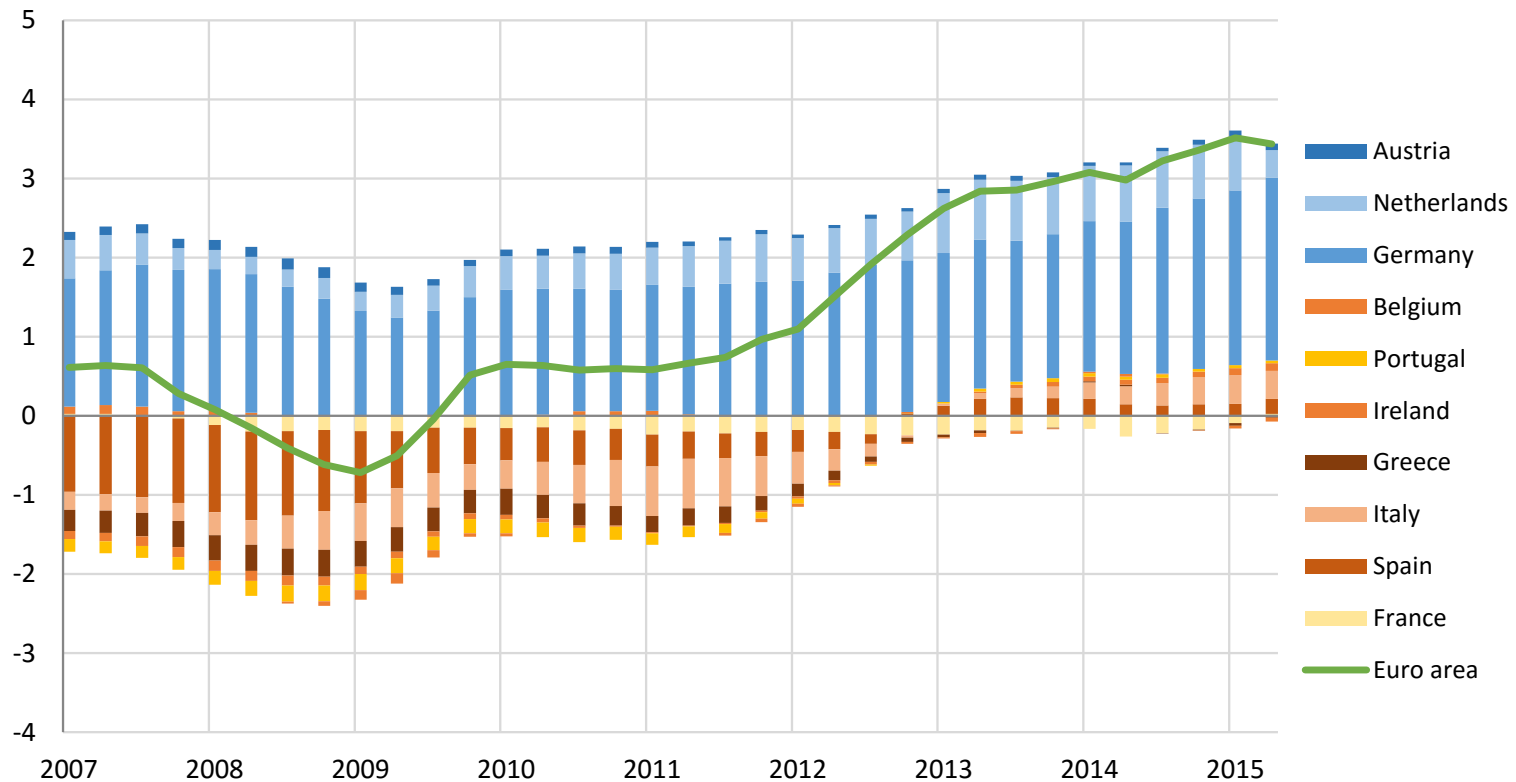
Source: Briefing “Non-performing loans in the Banking Union: stocktaking and challenges” European Parliament

Available online:

[http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/574400/IPOL_BRI\(2016\)574400_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/574400/IPOL_BRI(2016)574400_EN.pdf)

Imbalance #3 : External and internal imbalances

Current account in % of EA GDP



Source: national accounts, ECB, iAGS 2016 calculations. Current account is cumulated over 4 quarters.

Imbalance #3 : External and internal imbalances

Table 8. Nominal disadjustments with respect to Germany (2008-2014)

	2008	2009	2010	2011	2012	2013	2014
AUT	20.2	15.9	13.3	1.0	2.8	6.5	1.4
BEL	-32.9	-29.9	-15.7	-30.7	-23.8	-22.2	-23.2
DEU	0	0	0	0	0	0	0
ESP	-46.8	-32.8	-30.6	-29.9	-21.9	-15.3	-18.5
FIN	4.8	-1.2	-7.9	-29.0	-30.7	-28.4	-24.7
FRA	-18.9	-16.1	-16.6	-19.1	-19.8	-15.2	-19.1
GRC	-89.1	-87.9	-80.8	-73.0	-48.5	-39.7	-39.8
IRL	-26.8	-28.7	-25.6	-26.9	-28.7	-19.8	-14.9
ITA	-29.2	-25.2	-32.7	-31.9	-19.9	-12.0	-9.9
NDL	•4.5	6.1	6.2	4.4	5.1	6.8	0.8
PRT	-68.5	-65.3	-59.2	-43.1	-30.9	-17.1	-21.4

Source: iAGS calculation.

Imbalance #4 : Public debt

Table 3. Projection of public debt

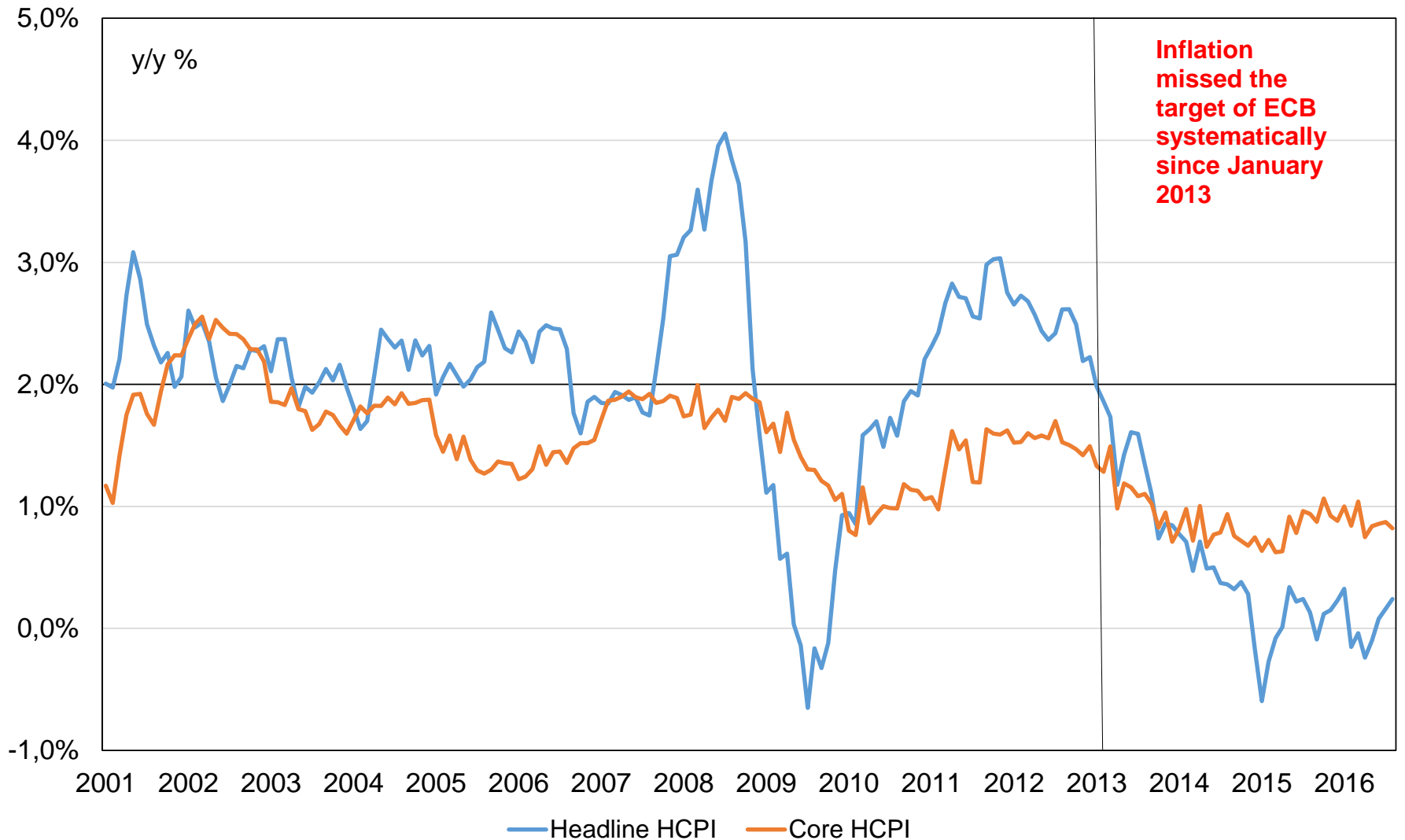
	Public debt (%GDP)		Structural balance (%GDP)		GDP growth rate (% yoy)		Inflation rate (% yoy)	
	2020	2035	2020	2035	2016-20	2021-35	2016-20	2021-35
DEU	57	24	0.8	1.4	1.3	1.0	1.8	2.0
FRA	95	97	-2.7	-3.6	1.9	1.4	1.2	2.0
ITA	123	80	0.3	1.1	1.2	0.2	0.7	2.0
ESP	96	89	-2.3	-2.7	2.3	1.4	1.1	2.0
NLD	67	62	-1.4	-1.9	1.7	1.3	1.2	2.0
BEL	102	87	-2.0	-2.1	1.8	1.5	0.9	2.0
PRT	110	49	0.9	2.5	1.9	1.0	0.9	2.0
IRL	76	21	0.9	2.6	2.6	1.8	1.8	2.1
FIN	65	74	-2.4	-3.3	2.1	1.6	1.3	2.0
AUT	83	69	-1.3	-1.5	1.6	1.4	1.2	2.0
EA	87	65	-0.8	-0.8	1.7	1.1	1.3	2.0

Source: AMECO (nov. 2015) for historical data. IAGS model simulation, forecasts and hypothesis, November 2015. Structural deficits in 2020 can be different from 2015 data because of change in potential growth endogenous to the model and variation in sovereign rates.

3) Dealing with multiple imbalances

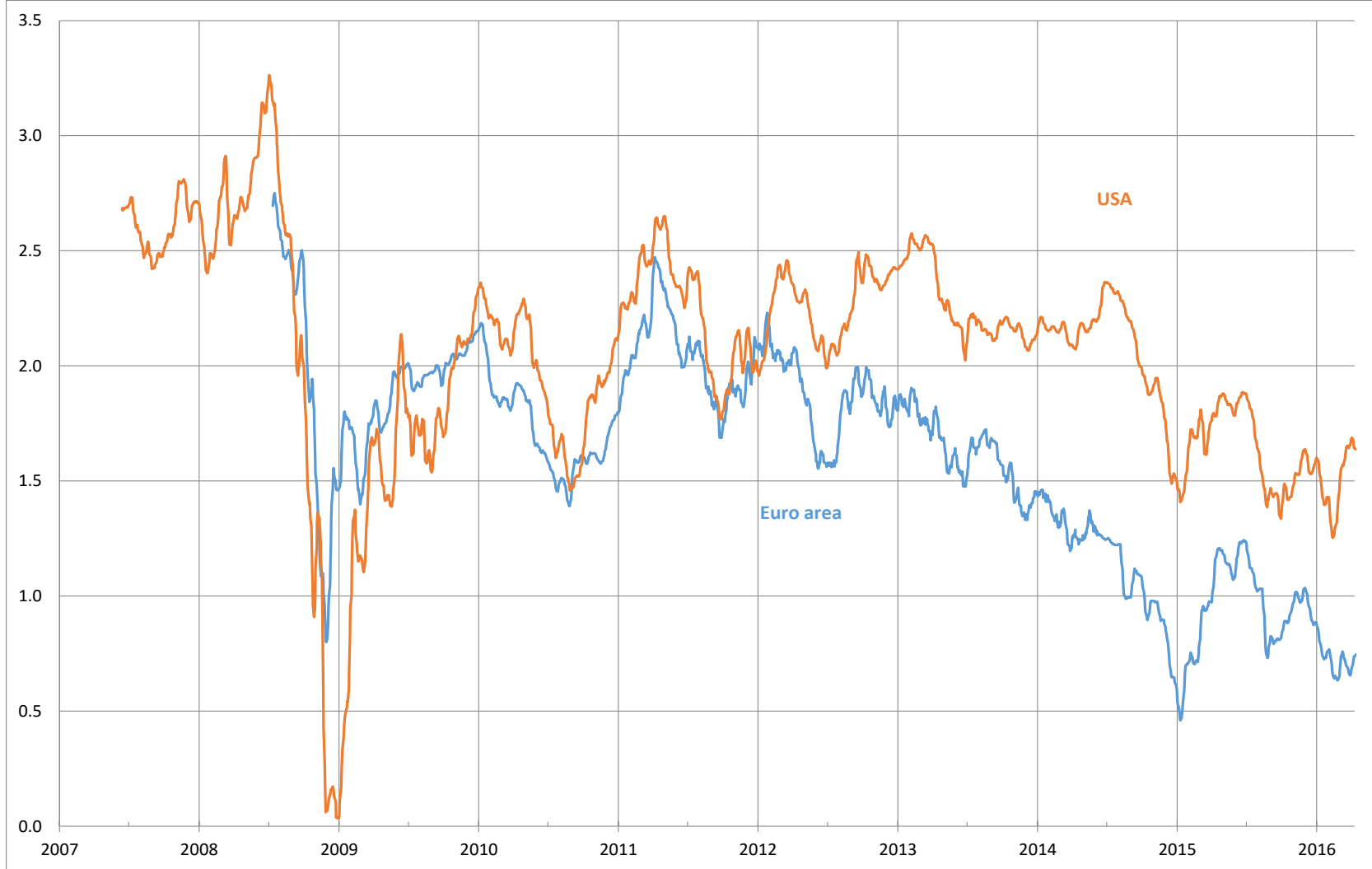
Challenge: Solve imbalances in a context of low inflation (1)

Euro Area: Harmonized consumer price index



Challenge: Solve imbalances in a context of low inflation (2)

Inflation expectations



Inflation expectations are measured using 5 Years Forward 5 Years Swap.

Source: Datastream

Challenge: Solve imbalances in a context of low inflation (3)

- **Low inflation deteriorate all the identified imbalances**
 - **Public finances:** lower fiscal revenues
 - Debt reduction is harsher --> need of more fiscal adjustment
 - **Real interest rate increase and downgrade private balance sheet**
 - Deleveraging is harsher and increase of banking risk
 - **Downward price rigidity makes harder to adjust relative prices between EA countries**
 - Longer internal rebalancing
 - **Real exchange rate appreciation:** if inflation is lower in the EA than in the rest of the world it makes harder to reach aggregate current account equilibrium

- **In this context tackling unemployment and its consequences is harsher**

- **New dominant narrative: structural reform + unconventional monetary policy + neutral aggregate fiscal stance**
 - Labor and product market liberalization
 - Supposed to improve simultaneously productivity / employment / GDP and hence debt sustainability
- **Structural reforms are unable to increase growth rate during recessions and in ZLB (Bordon, Ebeke, Shirono (2016))**
 - Deflationary shock
 - Lesson from 2010-2011 EA crisis: there is no silver-bullet. There is “no free lunch”. We have to deal with trade-offs.
- **Monetary policy is opening a window of opportunity**
 - It will be limited in time for various reasons (currency war, increase financial risks, distributional effect, institutional pressures)
 - Given the risks it can create it is not sure that unconventional monetary policy may last until the resolution of all the identified imbalances

- **Fiscal space has to be used as it is in the interest of surplus countries and is necessary to Euro stability**
 - This can be done without Treaty change
- **Investment is key: build new net assets and do not change net assets (no-debt sustainability problem)**
 - A golden rule at the country-level, monitoring at the EU-level the quality of investment projects
 - A true EA wide public investment plan? (Euro bonds / project bonds?)
 - Green New deal (iAGS 2015)
- **Social investment is also necessary to fight against the social scars of the crisis**
- **Fiscal policy should be complemented with fiscal coordination (fight against tax heavens, tax competition, fiscal devaluation)**

Demand management is needed (2)

Table 5. Loss/gain of relative nominal adjustment on EA countries

	Using fiscal space in all countries		Not using fiscal space in all countries	
	No Euro appreciation	Euro appreciation	No Euro appreciation	Euro appreciation
DEU	0.1	0.0	0.0	-0.2
FRA	-0.3	-0.4	-1.0	-1.2
ITA	0.1	-0.3	-0.1	-0.8
ESP	-0.1	-0.1	-0.1	-0.1
NLD	0.1	0.1	0.2	0.1
BEL	-0.1	0.0	0.1	0.3
PRT	-0.1	0.0	-0.1	0.0
IRL	0.0	0.0	0.0	-0.1
GRC	0.0	0.0	0.5	0.4
FIN	-0.3	-0.2	0.0	0.1
AUT	0.2	0.2	0.3	0.2
EA	0.0	-0.1	-0.2	-0.4

Note: The impact is defined as the average loss of output, or equivalently of the increase in unemployment, over the period 2016-2035, each year.

Source: IAGS calculations, historical data from AMECO November 2015. Euro appreciation in scenario without using fiscal space is higher (25% REER) than in scenario using fiscal space (10% REER) because of a lower EA current account in that scenario. See chapter 3 of 2016 IAGS for discussion.

- **Internal rebalancing may have repercussion on deflation**
 - Wage push in surplus countries is a way to avoid that
 - Coordination in minimum wage fixation (iAGS 2013)
 - Non cost competitiveness has to be implemented

- **There 4 major imbalances in EA**
 - High unemployment
 - Financial risks
 - External and internal imbalances
 - Public debt

- **There is no “silver bullet”**: you should design a policy framework that deals with all the challenges

- **Actual framework creates divergence forces in Europe and deflation: ECB is unable to tackle alone this risk**

- **A Coherent solution:**
 - Demand management with sustainable public finances (golden rule, fiscal space): better economic situation should reduces banking sector fragility
 - Public investment plan (with EU debt?): Green New deal
 - Coordination of wage setting through minimum wage (internal imbalances, risk of deflation and social crisis)