Hochschule für
Wirtschaft und Recht Berlin
Berlin School of Economics and Law

Coping with Imbalances in the Euro Area: Policy Alternatives Addressing Divergences and Disparities between Member Countries

Eckhard Hein and Daniel Detzer
(Berlin School of Economics and Law)

18th Conference of the Research Network Macroeconomics and Macroeconomic Policies (FMM)
„Inequality and the Future of Capitalism“,
Berlin, 30 October – 1 November, 2014

This project is funded by the European Union under
the 7th Research Framework programme (theme SSH)
Grant Agreement nr 266800

1. Introduction

2. Theoretical framework

3. The general stance required for policy alternatives

4. More concrete policy proposals for the Euro area

4.1 Monetary policy

4.2 Wage and incomes policy

4.3 Fiscal policy

5. Industrial restructuring and catching-up of the periphery

5.1 Efficient regulation of and selective interventions into capital flows

5.2 Industrial and regional policy strategy

5.3 Stable long-term financing of current account deficits related to successful catching up

6. Conclusions

2. Theoretical framework

Thirlwall's (1979; 2002): 'balance-of-payments-contrained growth rate' (BPCGR) in a currency union

(1) $$\hat{Y}_d^b = \frac{(1+\eta+\psi)(\hat{p}_d - \hat{p}_f) + \varepsilon\hat{Y}_f}{\pi}, \qquad \eta, \psi < 0, \quad \varepsilon, \pi > 0,$$

With equal inflation rates

(2) $$\hat{Y}_d^b = \frac{\varepsilon\hat{Y}_f}{\pi} = \frac{\hat{X}}{\pi}.$$

Causes for CA imbalances in a currency union: $\hat{Y}_d \neq \hat{Y}_d^b$

1. Actual growth differentials between the different Euro area countries exceed those implied by the respective BPCGRs
2. BPCGR deviates from 'given' actual growth rates

a. too high inflation differentials (differentials in nominal unit labour cost growth, but also changes in mark-ups and other input costs)

b. too low income elasticities of exports and too high income elasticities of imports for CA deficit countries.

3. The general stance required for policy alternatives

- Target: high non-inflationary demand growth in the Euro area as a whole, preventing ‘export-led mercantilist’ and ‘debt-led consumption boom’ types of development

- Short run: stimulate aggregate demand and growth in the CA surplus countries relative to the Euro area average trend, and dampen aggregate demand and growth relative to the Euro area average in CA deficit countries and adjust inflation differentials (nulc growth)

- Long run: improve non-price competitiveness of CA deficit countries and develop stable financing mechanisms for CA deficits associated with catch-up growth lifting the BPCGR:

(3) $$\hat{Y}_d^b = \frac{(1+\theta\eta+\psi)(\hat{p}_d-\hat{p}_f)+\theta\varepsilon\hat{Y}_f+(1-\theta)(\hat{C}-\hat{p}_d)}{\pi},$$

(4) $$\hat{Y}_d^b = \frac{\theta\varepsilon\hat{Y}_f+(1-\theta)(\hat{C}-\hat{p}_d)}{\pi} = \frac{\theta\hat{X}+(1-\theta)(\hat{C}-\hat{p}_d)}{\pi}.$$

4. More concrete policy proposals for the Euro area

Coordination is required: ‘policy package’

- intra-coordination of national, as well as European institution within the respective policy area,
- inter-coordination among areas of policy making at national and European levels,

➔ Macroeconomic Dialogue and a completely revamped European Semester

4.1 Monetary policy

- Take into account long-run distribution, employment and growth effects and refrain from fine-tuning inflation or other macro-variables
- target low real long-term interest rates (below productivity or real GDP growth trend)
- focus on financial stability: credit standards, reserve requirements for different types of assets, credit controls in order to channel credit into desirable areas and to avoid credit-financed bubbles in certain markets
- lender of last resort for the banking system but also for Euro area member countries:
  ECB should announce that it will intervene into secondary government bond markets as soon as the rate of interest on government bonds exceeds the long-run nominal rate of growth of the respective country
- country specific cap on government bond yields:

(5) $$i_j \leq \hat{p}_j + \hat{Y}_j .$$

(Alternative: De Grauwe 2011: Euro area wide cap – 2 per cent above German rate)

4.2 Wage and incomes policy

- Contribute to stabilising income shares and inflation at Euro area target rate

(6) $$\hat{w}_j = \hat{y}_j + p^T,$$

- Contribute to rebalancing (Stockhammer/Onaran 2012):

(7) $$\hat{w}_j = \hat{y}_j + p^T + \alpha\left(ULC_{EA} - ULC_j\right),$$

- Abandon the dominating policies of labour market flexibilisation and of gaining competitiveness by means of nominal wage restraints (cuts)
- Re-regulation of labour market, stabilisation of labour unions and employer associations
- Euro-area wide minimum wage legislation: ETUC (2012): at least 50 per cent of the average wage or 60 per cent of the median wage in the respective member countries
- OFCE/IMK/ECLM (2013): increase minimum wage by 2 per cent (plus national productivity growth) per year

However: price competitiveness seems to be of little relevance for CA imbalances within the Euro area:

Arghyrou/Chortareas (2008, p. 752) for Euro are member states (1975-2005): “relative incomes have been playing a more prominent role than real exchange rates in long-run current account determination.”

European Commission (2010, p. 10): “[a] large part of the cross-country divergence in the current account since the late 1990s is rooted in domestic demand factors.”

Carasco/Peinado (2014) : panel estimations for the Euro area member countries (1995 – 2012): considerable structural component representing effects of the industrial structure and the non-price competitiveness of a country on its current account

Schröder (2011), Storm/Naastepad (2014), Kollmann et al. (2014): only small effects of price competitiveness on the German trade balance in their estimations, which is almost completely explained by foreign demand.

➔ Major burden for internally rebalancing the Euro area falls on fiscal policy – demand management and industrial restructuring!!

4.3 Fiscal policy

Focus on real stabilisation, full employment and also a more equal distribution of disposable income.

(8) $S - p_d I = p_d X - p_f eM + G - T$.

With a balanced current accounts ($p_d X - p_f eM = 0$) government deficits in the long-run perspective (D_L) have to permanently take up the excess of private saving over private investment:

(9) $D = G - T = S - p_d I$.

(10) $\frac{B}{Y^n} = \frac{\frac{D}{Y^n}}{\hat{Y}^n}$.

Low interest rates (i < g) are important for distributional reasons.

Permanent government deficits for public investment in a wider sense (including increasing public employment) + short-run stabilisation in case of cyclical shocks:

(11) $D = D_L + D_S(Y^T - Y)$, $D_S > 0$.

Progressive income taxes, relevant wealth, property and inheritance taxes, as well as social transfers reduce excess saving and improve automatic stabilisers.

- Abandon SGP and further ‘developments’: the ‘Six-Pack’, the Euro-Plus Pact, the Fiscal Compact, and the austerity policies imposed on the crisis countries

- Coordination of long-run expenditure paths for non-cyclical government spending (Hein/Truger (2007), Hein/Truger/van Treeck (2012)): For each member country: on average over the cycle and the average net tax rate given, the path for non-cyclical government expenditure should generate a ‘structural’ government deficit/surplus balancing the ‘structural’ private sector surplus/deficit at high levels of non-inflationary employment and a roughly balanced current account

- Expenditure paths should be coordinated and monitored by the European Commission and the unwillingness to correct deviations should be finally sanctioned

- ECB keeping nominal interest rates in each country below trend nominal GDP growth of the respective country, will make sure that debt services will not have restrictive distributional effects

- Domestic demand in CA surplus countries will be raised, allowing CA deficit countries to reduce CA deficits

- Domestic demand in CA deficit countries will be reduced – alternative: improve BPCGR through higher income elasticity of demand for their exports and lower the income elasticity of demand for imports ➔ industrial, structural and regional policies

The problem of long-run growth differentials (due to catching-up..)

- No compensation by reverse inflation differentials or inverse relative income elasticities of demand for exports and imports

➔ deviation of GDP growth from BPCGR

➔ CA deficits and surpluses which should be tolerated by coordinated fiscal policies

➔ **Criterion for tolerable CA deficits: growth of deficit country is sustainable and exceeds average growth of surplus countries**

➔ no ‚one size fits all‘ as in Dullien/Schwarzer (2009) (+/- 3 per cent) or Horn et al. (2010) (+/- 2 per cent)

➔ Foreign liabilities-GDP-ratio of a deficit country cannot explode with constant CA deficit-GDP ratio and the higher the growth rate the higher the tolerable CA deficit-GDP ratio

(12) $$\hat{Y}_d^n = \hat{L}_d = \frac{\Delta L_d}{L_d} = \frac{\frac{\Delta L_d}{Y_d^n}}{\frac{L_d}{Y_d^n}} \quad \Rightarrow \quad \frac{L_d}{Y_d^n} = \frac{\frac{\Delta L_d}{Y_d^n}}{\hat{Y}_d^n}$$

Alternatives to coordination member countries' fiscal policies: EU or EMU budget

1. European Commission (2012a, 2012b), Van Rompuy et al. (2012): 'fiscal capacity' a insurance system for country-specific shocks, deeply linked with current austerity and structural reform policies
2. Tommaso Padoa-Schioppa Group (2012): cyclical stabilisation insurance fund + European Debt Agency, built-in incentives towards restrictive fiscal policies in times of crisis because of loss of sovereignty
3. Dullien (2013), Dullien/Fichtner (2013): Euro area unemployment insurance, dampens asymmetric shocks but no aggregate stabilisation
4. Bibow (2013): Euro Treasury for debt-financed public investment, re-establishes link between central bank and fiscal authorities, aggregate stabilisation, but relies on adjustment of price competitiveness by means of wage policies for CA rebalancing

5. Industrial restructuring and catching-up of the periphery

Three general prerequisites for a sustainable catching up process:

- prevent unsustainable credit-driven bubbles and consumption booms
- capital inflows should be focused on productivity enhancing investment and the development of export capacities
- and they should be integrated into a European regional and industrial development strategy

5.1 Efficient regulation of and selective intervention into capital flows

- Financial regulation should be used to prevent credit driven bubbles
  - Microprudential regulation
    - E.g. access to credit only based on disposable income and not on collateral values; real estate financing with conservative LTV ratios and high equity stakes; loans for speculative purposes should be strictly regulated
  - Macroprudential regulation
    - New national instruments introduced with Capital Requirement Regulation and CRD ➔ allows for higher capital requirements, higher risk weights and lower limits for certain loans
    - European Systemic Risk Board monitors macroprudential risks and uses “Act-or-Explain” Mechanism
    - However, need for a European Regulator which is willing to “take away the punch bowl” and has the necessary instruments, e.g. Assets Based Reserve Requirements or direct credit controls

5.2 Industrial and regional policy strategy

- develop productive capacities, increase productivity and improve export capacities

- Botta (2014): strategies should have strong regional character (no ‘one size fits all’)
- Promote ‘high road competitiveness’, based on high-quality manufacturing production as the driver of growth (Aiginger 2014; Simonazzi et al. 2013), but consider constraints given by existing structures (Simonazzi et al. 2013)
- Focus on exports with increasing returns and high income elasticity (Thirlwall/Pacheco-Lopez 2008)
- Private and public investment in infrastructure, education, basic and applied research and development: several proposals by DGB (2012), OFCE/IMK/ECLM (2013),…
- Development requires protection (Thirlwall/Pacheco-Lopez 2008), but public sector credit and guarantees may be better and more realistic (Hausmann/Rodrik 2002): national development banks, EIB, etc.

5.3 Stable long-term financing of current account deficits related to successful catching up

- Capital controls within EU are not available, therefore:
- Use of financial regulation (e.g. Liquidity requirements, Financial transaction tax) to influence maturity of private capital inflows
- Public sovereign wealth funds in surplus countries mopping up private excess saving (Gros/Mayer 2013)
- Pool large parts of investment spending at EU level with focus on catching-up countries, finance by member country contributions, EU taxes and/or EU debt:
- DGB (2014): European Future Fund (one time wealth levy and ftt);
- Varoufakis/Holland/Galbraith 2013): European investment program, by EIB, EIF and a newly created venture capital fund, ECB manages low interest rates
- Bibow (2013): Euro Treasury should pool investment, funding it by Euro Treasury bonds

- Thank you

17