

The role of shocks and institutions in EMU and the US during the crisis

Rafael Doménech

July 25, 2013

Outline

1. Introduction

2. The role of shocks

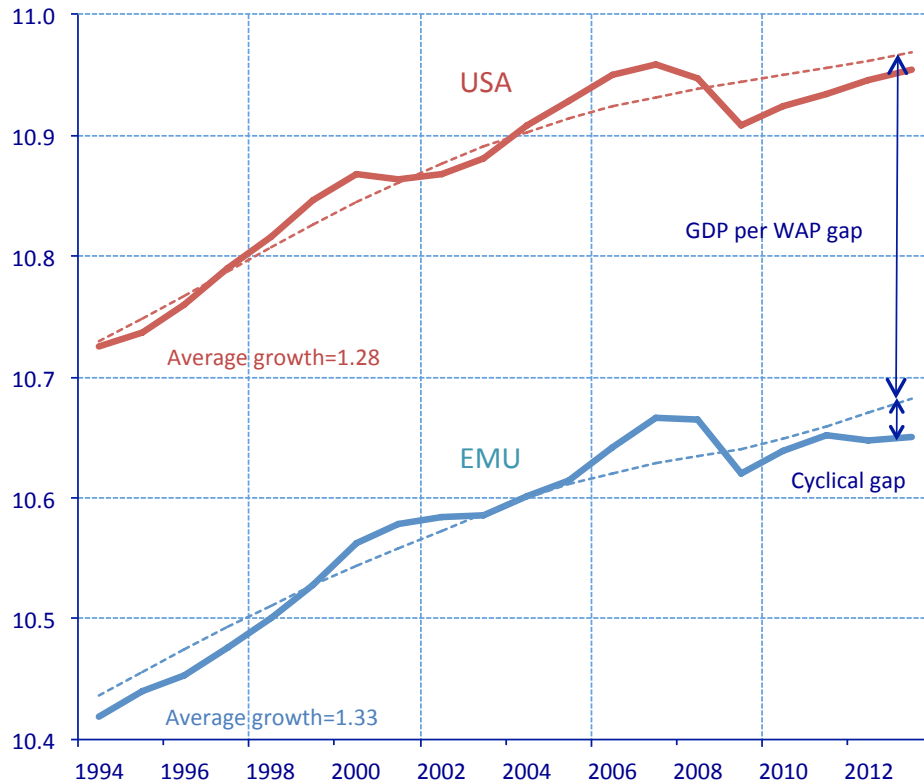
3. The role of institutions

4. Conclusions

The crisis in EMU and the USA

GDP per working-age population

Source: BBVA Research



Both the USA and EMU suffered an intense recession in 2008 and 2009 ...

... caused by a financial crisis with huge effects on international trade

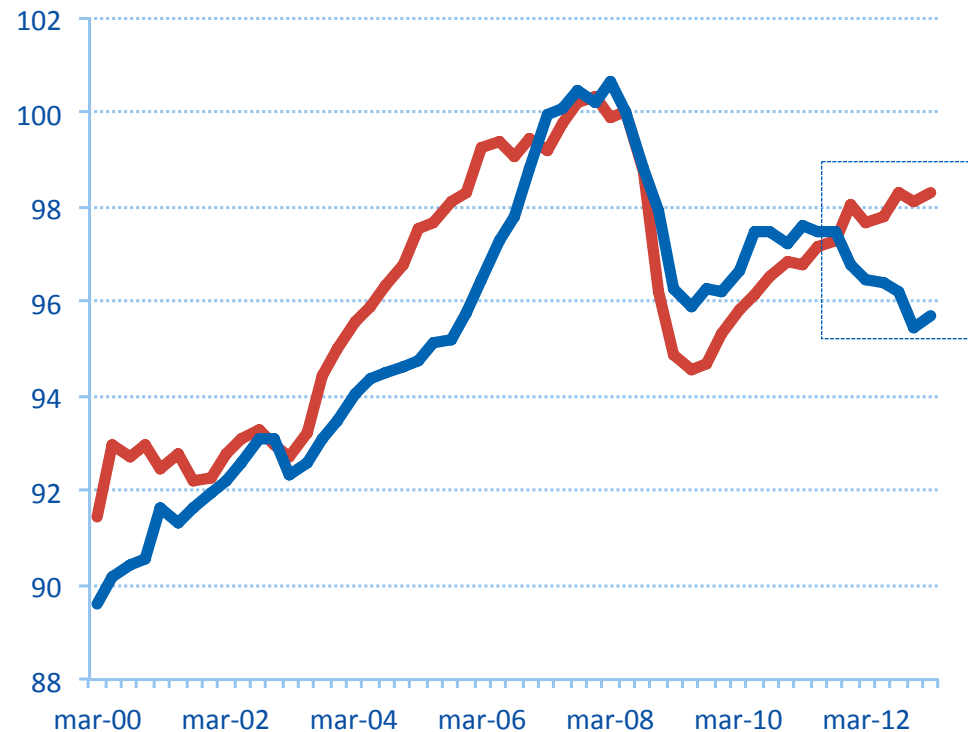
But EMU has suffered an additional sovereign debt crisis*, with important implications in terms of its cyclical gap

(* See Andrés and Doménech (2012a), Lane (2012) and Shambaugh (2012)

The crisis in EMU and the USA

GDP per working-age population (2Q2008=100)

Source: BBVA Research



The USA has recovered 2/3 of the fall in GDP per working-age population

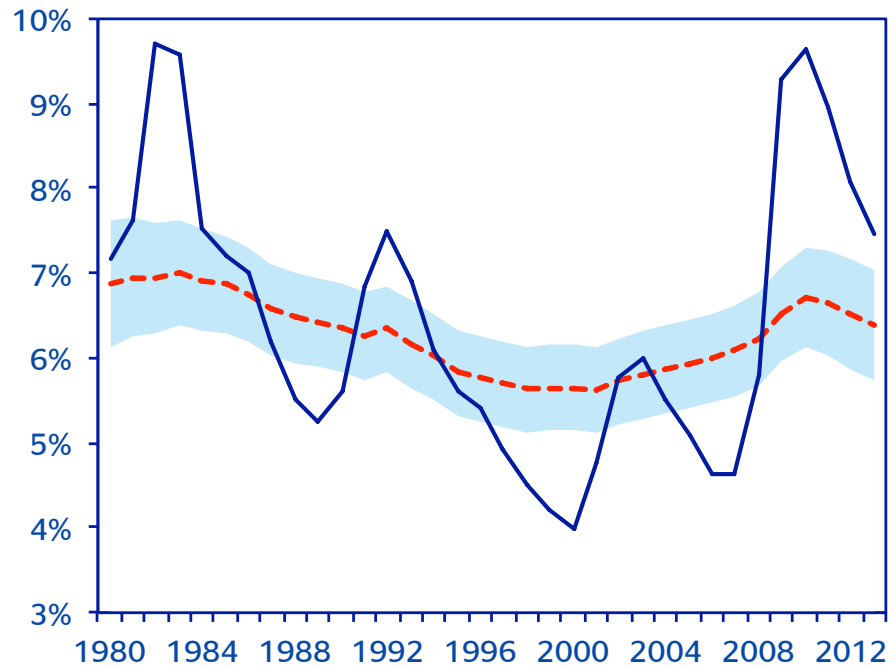
The sovereign debt crisis in EMU put an end to the recovery of 2010 and 1H2011 ...

... such that the current level of GDP per working-age population is slightly lower than in 2009

Two different dynamics of the unemployment rate

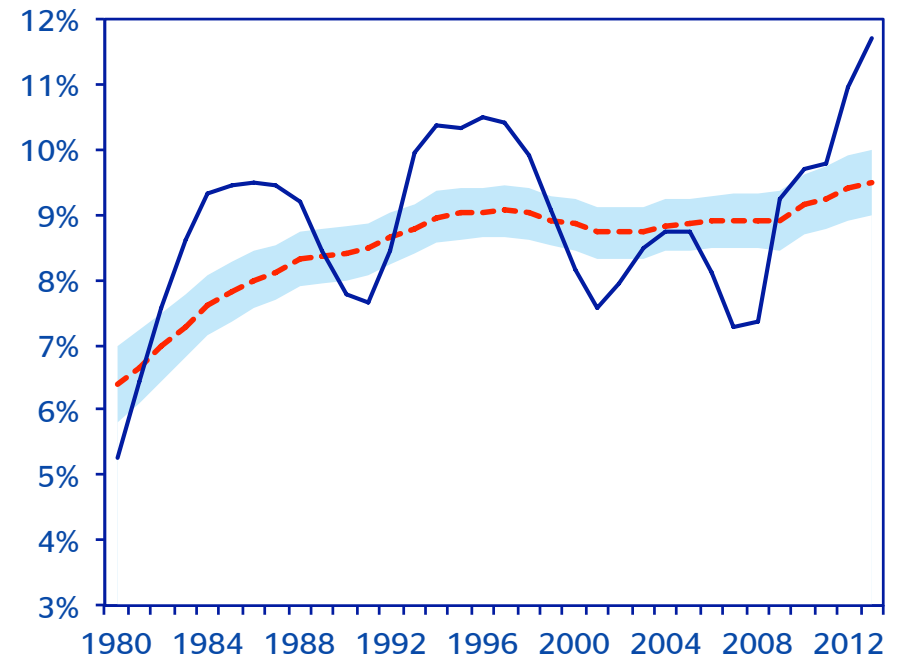
USA: unemployment rate and the NAIRU

Source: BBVA Research



EMU: unemployment rate and the NAIRU

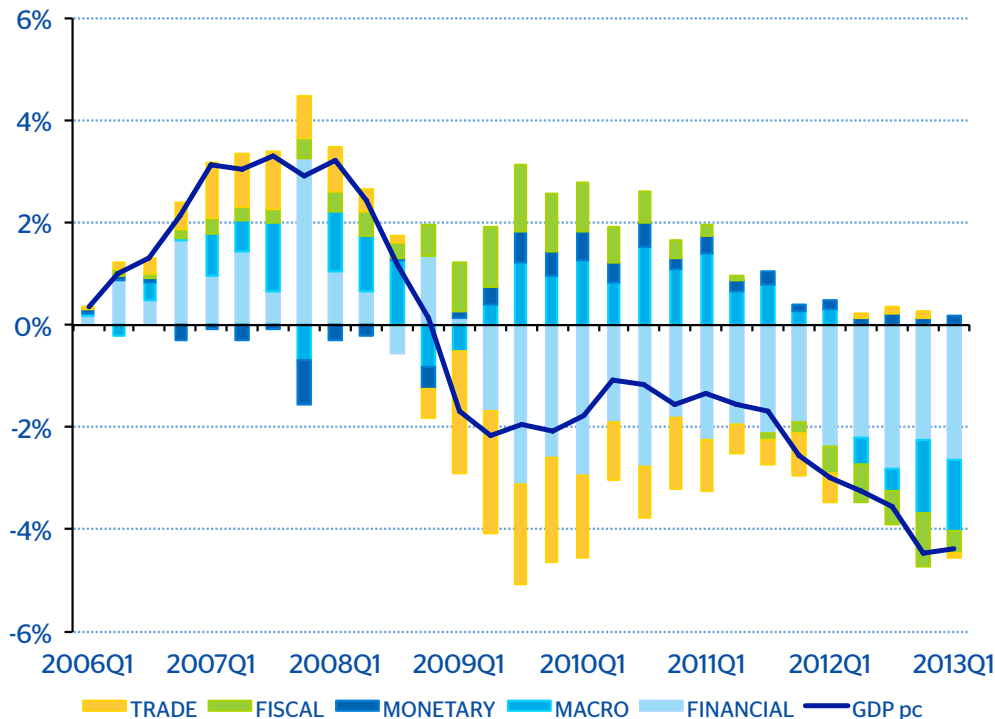
Source: BBVA Research



Structural shocks and their effects in EMU

Decomposition of GDP per working-age population: cyclical component

Source: BBVA Research



2H2008 to 1H2011: (1) negative financial and international trade shocks, (2) fiscal expansion

2H2011 to 1Q2013: (1) negative financial and fiscal shocks (2) positive international trade shock

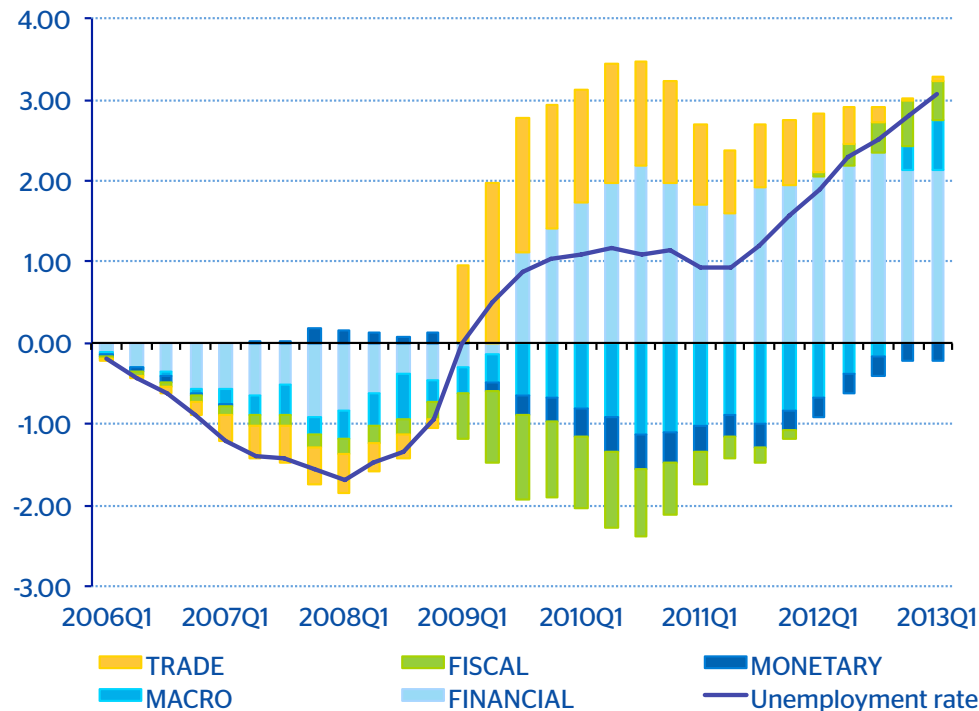
Monetary policy has been accommodative to cyclical conditions

(* See Doménech, García, Méndez-Marcano and Rubio-Ramírez (2013),

Structural shocks and their effects in EMU

Decomposition of the cyclical component of the unemployment rate

Source: BBVA Research



2H2008 to 1H2011: (1) negative financial and international trade shocks, (2) fiscal expansion

2H2011 to 1Q2013: (1) negative financial and fiscal shocks (2) positive international trade shock

Labour market shocks have contributed to a smaller increase of the unemployment rate

(* See Doménech, García, Méndez-Marcano and Rubio-Ramírez (2013),

Differences between the USA and EMU caused by ...

... shocks?

1. Financial shocks

2. International trade

3. Fiscal shocks

4. Supply shocks

... their interaction with institutions?

5. Monetary policy

6. Financial integration: banking union

7. Fiscal integration

8. Economic integration

... or aggregate imbalances?

Imbalances in EMU and the US before the sovereign crisis

(% GDP)

Source: AMECO, Haver, IMF, national sources and BBVA Research

		EMU	US
Public deficit	2011	-4,4	-9,6
Public debt	2011	87,6	100,0
Households debt	2010	67,3	92,1
Firms debt	2010	119,1	74,6
Current account balance	2011	0,1	-3,1
Net external debt	2010	-7,2	-17,0

EMU had smaller aggregate imbalances than the US ...

... in public, private or external sectors ..

... but with a high internal heterogeneity ->

... but high internal heterogeneity across EMU countries

Macroeconomic imbalances in EMU (Six Pack), 2010

Source: BBVA Research, Eurostat and Haver

	Belgium	Denmark	Germany	Ireland	Greece	Spain	France	Italy	Netherlands	Austria	Portugal	Finland	EMU
Current account	-0.6	3.9	5.9	-2.7	-12.1	-6.5	-1.7	-2.8	5.0	3.5	-11.2	2.1	-1.4
Net IIP	77.8	10.3	38.4	-90.9	-92.5	-89.5	-10.0	-23.9	28.0	-9.8	-107.5	9.9	-21.6
Real exchange rate	1.3	1.0	-3.0	-5.0	3.9	0.6	-1.4	-1.0	-1.0	-1.3	-2.4	0.3	-0.7
Export shares	-15.4	-15.3	-8.3	-12.8	-20.0	-11.6	-19.4	-19.0	-8.1	-14.8	-8.6	-18.7	-14.3
ULC	8.5	11.0	6.6	-2.3	12.8	3.3	7.2	7.8	7.4	8.9	5.1	12.3	7.4
Housing prices	0.4	0.6	-1.0	-10.5	-6.8	-4.3	3.6	-1.5	-2.9	-1.5	0.1	6.6	-1.4
Private credit	13.1	5.8	3.1	-4.5	-0.7	1.4	2.4	3.6	-0.7	6.4	3.3	6.8	3.3
Private debt	232.8	244.2	128.1	341.3	124.1	227.3	159.8	126.4	223.4	165.7	248.5	177.7	199.9
Public debt	96.2	43.4	83.2	92.5	144.9	61.0	82.3	118.4	62.9	71.8	93.4	48.3	83.2
Unemployment rate	7.7	5.6	7.5	10.6	9.9	16.5	9.0	7.6	3.8	4.3	10.4	7.7	8.4

Outline

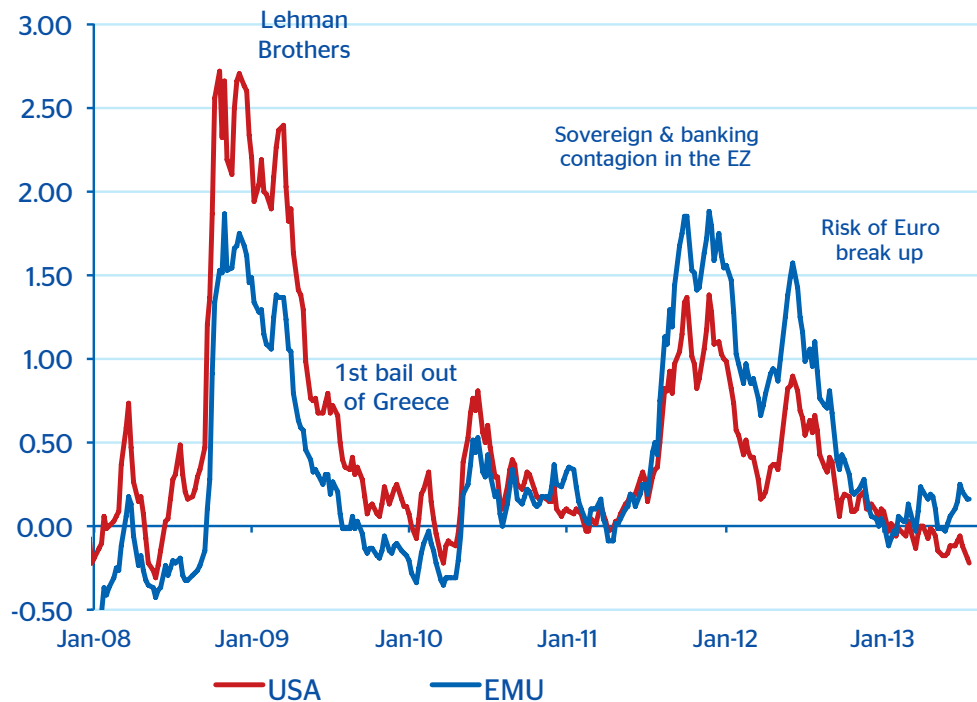
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4. Conclusions

1. Financial shocks

Financial tensions during the crisis

BBVA financial tensions index

Source: BBVA Research



2008-9: Financial shock much more intense in the USA than in EMU

2H2011 to 1H2012: sovereign debt crisis in EMU and contagion in the USA

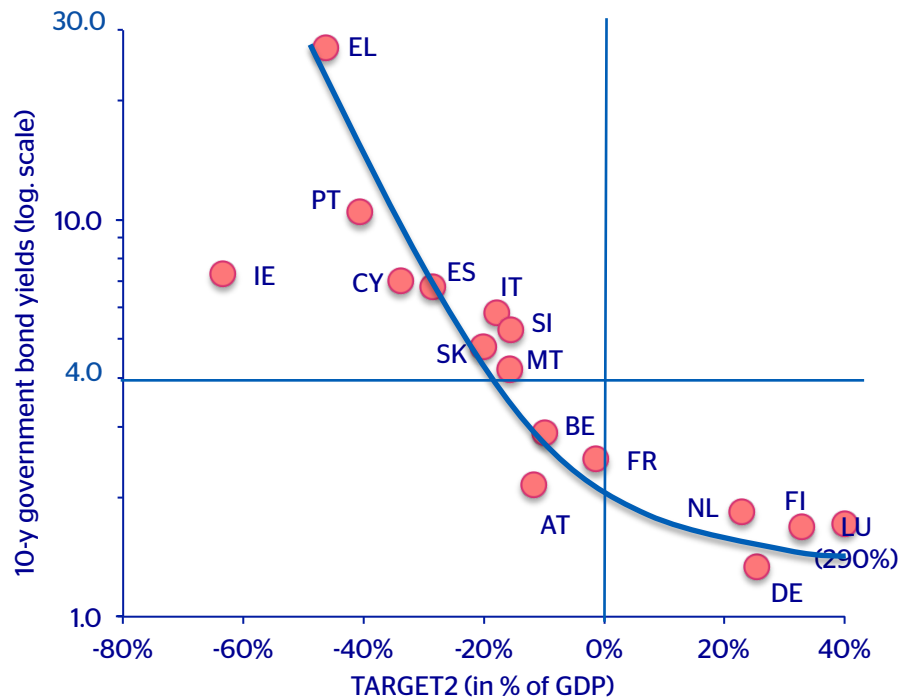
Now EMU has an opportunity window that should be opened up to ensure the economic recovery

1. Financial shocks

Financial fragmentation still high

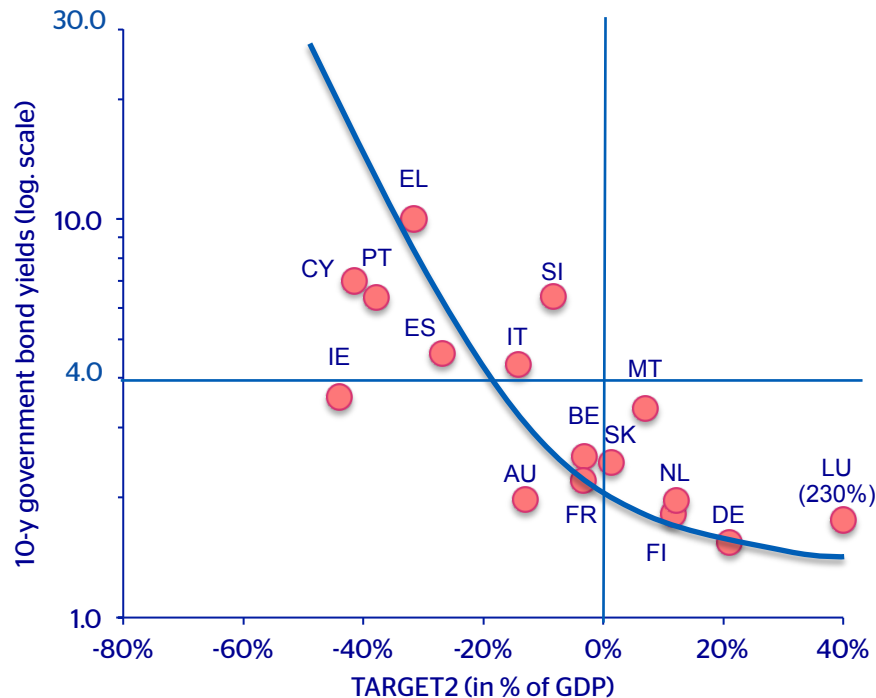
Interest rates and TARGET2, June 2012

Source: ECB and BBVA Research, June 2012



Interest rates and TARGET2, June 2013

Source: ECB and BBVA Research, June 2012



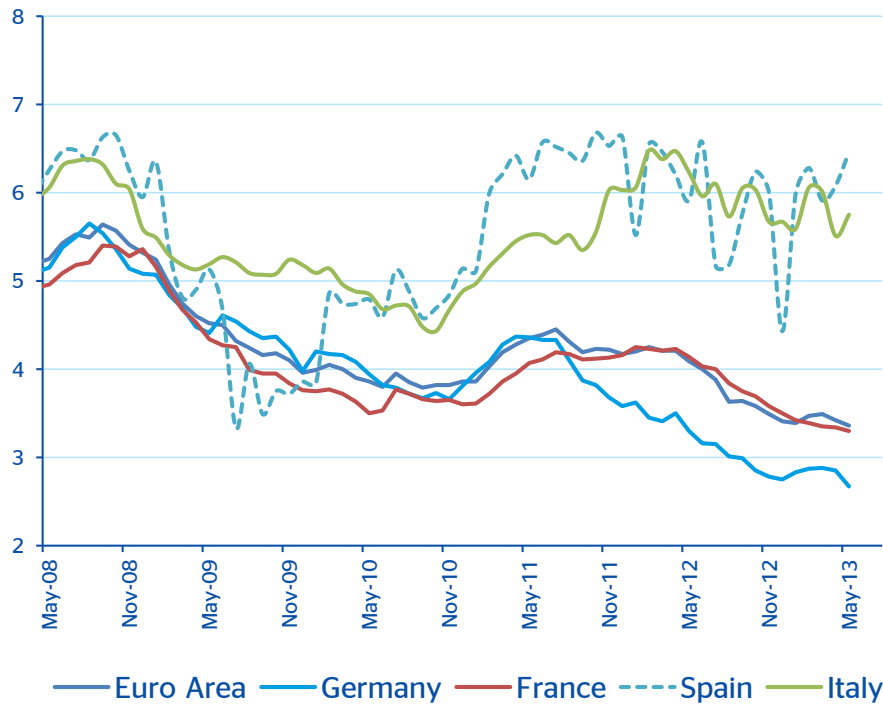
1. Financial shocks

Financial fragmentation still high

Interest rate of new loans to businesses

(Up to one million un euros, more than 5 years)

Source: ECB



Financial tensions have declined significantly from August 2012 ...

... but financial fragmentation is still high across countries ...

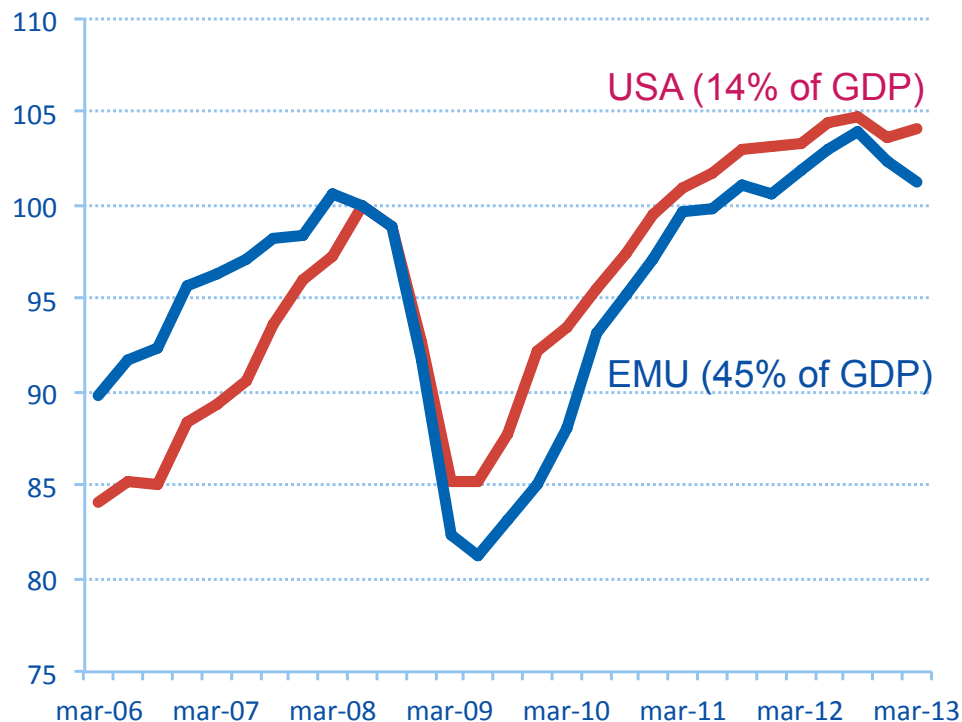
... creating very heterogeneous financial conditions for the recovery

2. External shocks

International trade has recovered above pre-crisis levels

USA and EMU: Exports levels (2Q2008=100)

Source: BBVA Research



The external shock in 2H2008 was huge: a fall of 15-20% in exports levels

The recovery of exports has been quite similar in EMU and the USA

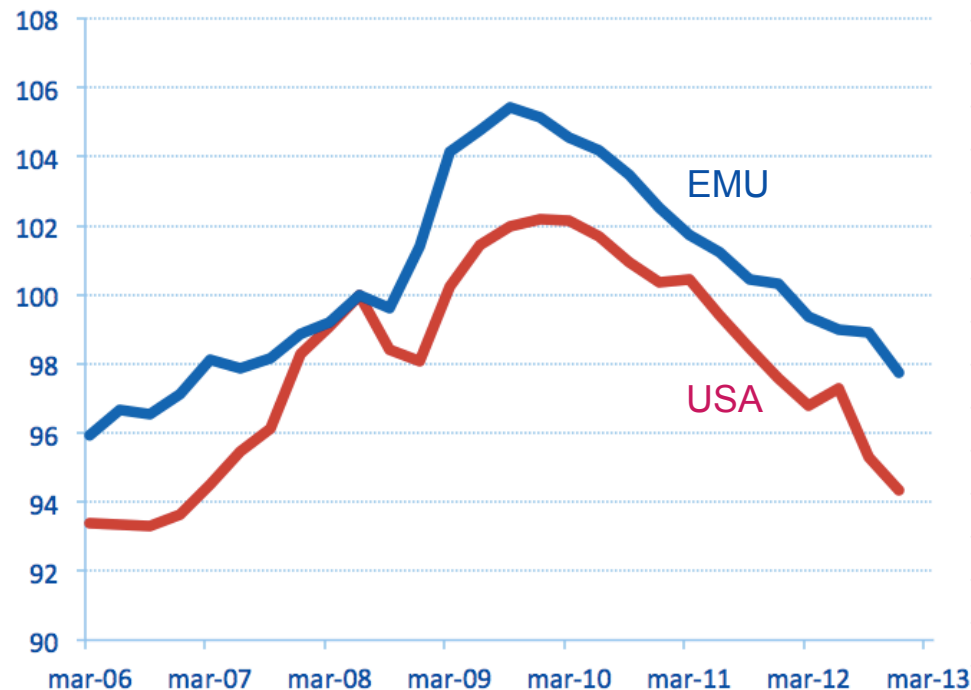
The contribution of exports to GDP are three times larger in EMU than in the USA

3. Fiscal shocks

Similar patterns of public consumption and investment ...

USA and EMU: Public consumption and investment per working-age population (2Q2008=100)

Source: BBVA Research



Despite the conventional wisdom, the patterns of public consumption and investment per working-age population have been quite similar ...

... first during the fiscal expansion and later during the fiscal consolidation (-8 pp)

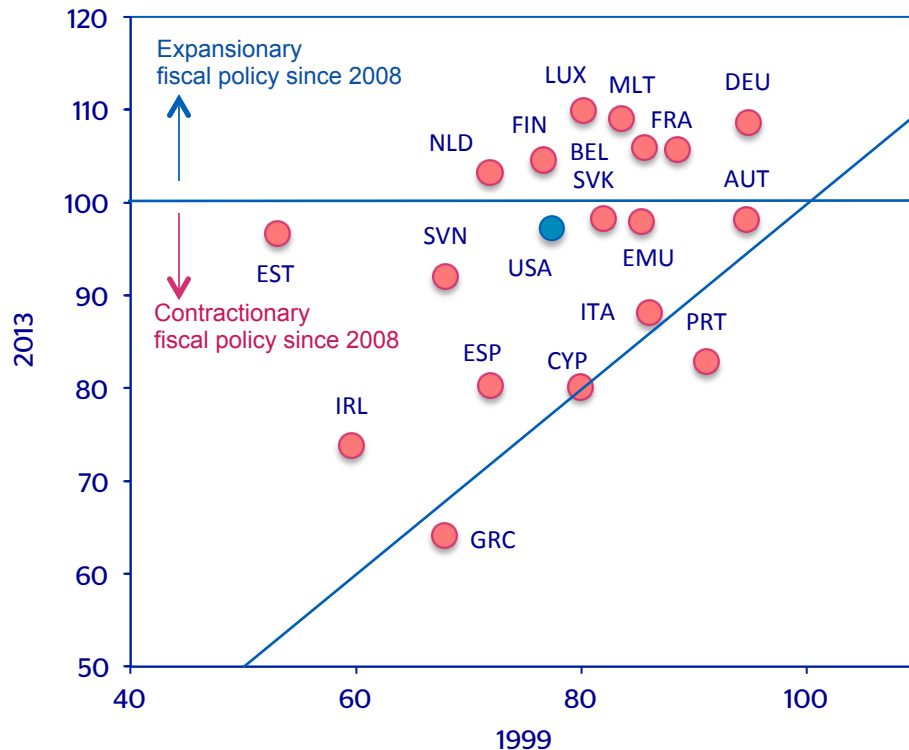
Both in EMU and the USA current levels are similar to those observed in 1Q2007

3. Fiscal shocks

... with a great heterogeneity across EMU countries

EMU: real public consumption and investment per working-age population in 1999 and 2013 (2008=100)

Source: AMECO and BBVA Research



The response of real public consumption and investment has been very heterogeneous in EMU ...

... with some countries applying expansionary fiscal policies ...

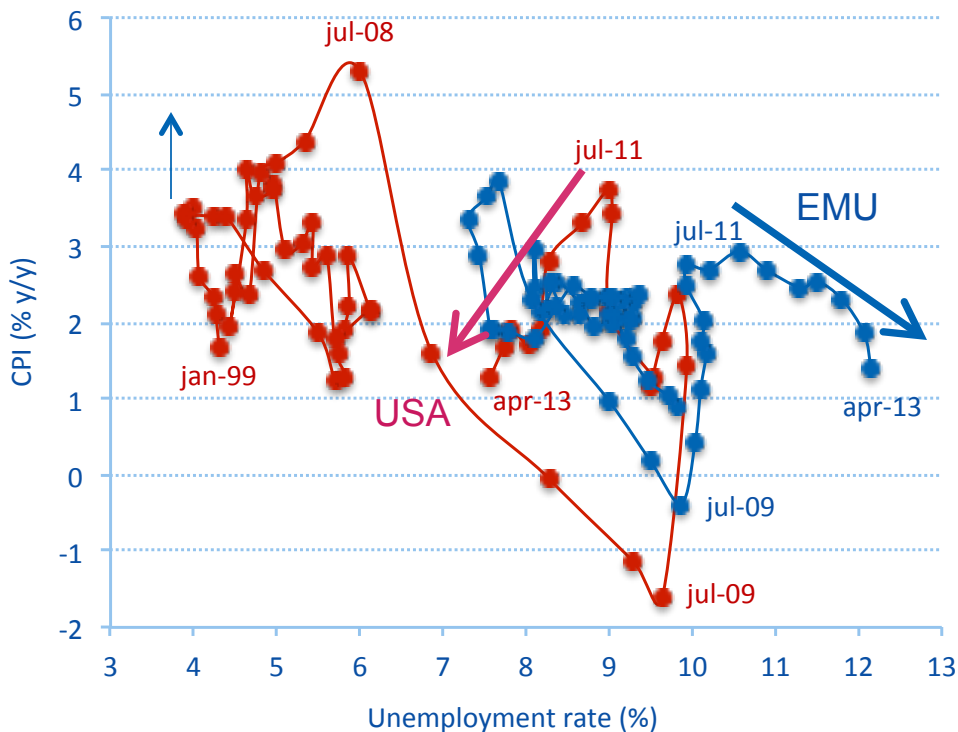
... whereas others, with high growth of public expenditures from 1999 to 2008, have been implementing a contractionary fiscal policy

4. Supply shocks

Different unemployment and inflation dynamics

USA and EMU: Phillips curves

Source: BBVA Research



New empirical evidence on the Phillips curve suggests that is flatter today than in the past (IMF, 2013)

Although headline inflation is at similar levels in the USA and EMU, unemployment dynamics are different

Inflation and unemployment dynamics from 2011 are consistent with a negative demand shock in EMU and a positive supply shock in the USA

Preliminary conclusions about the role of shocks

1. Financial shocks: more intense in the USA than in EMU
in 2008 and 1H2009

2. Similar international trade shocks

3. Similar fiscal shocks

4. Some evidence of positive supply shocks in the USA

Outline

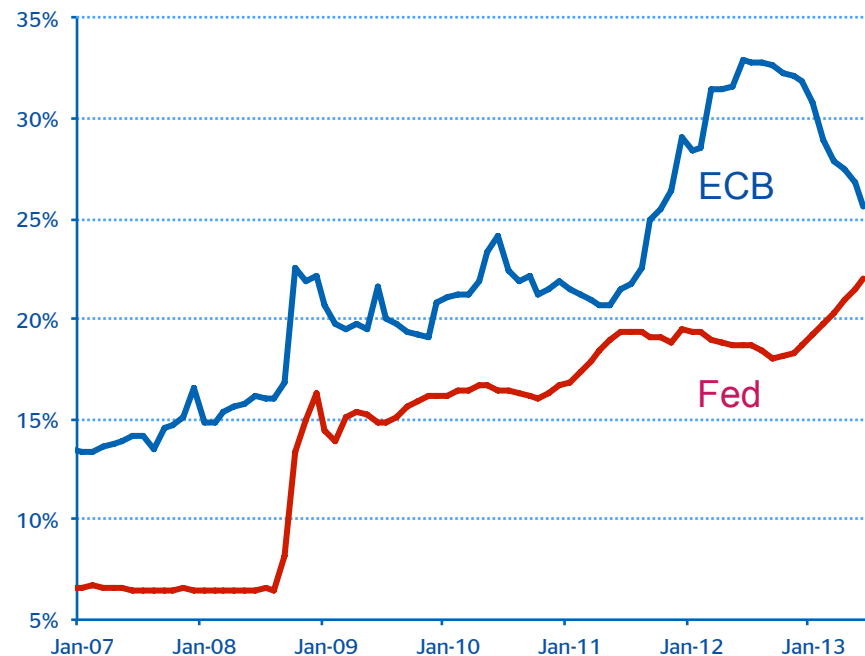
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5. Monetary policy

Differences in size and timing, ...

Central bank balance sheet as % of GDP

Source: Bloomberg and BBVA Research



Both the Fed and the ECB have increased their balance sheets in response to the crisis, but with some significant differences:

1. Size: the size in terms of GDP has increased by 4x in the Fed and 2x in the ECB

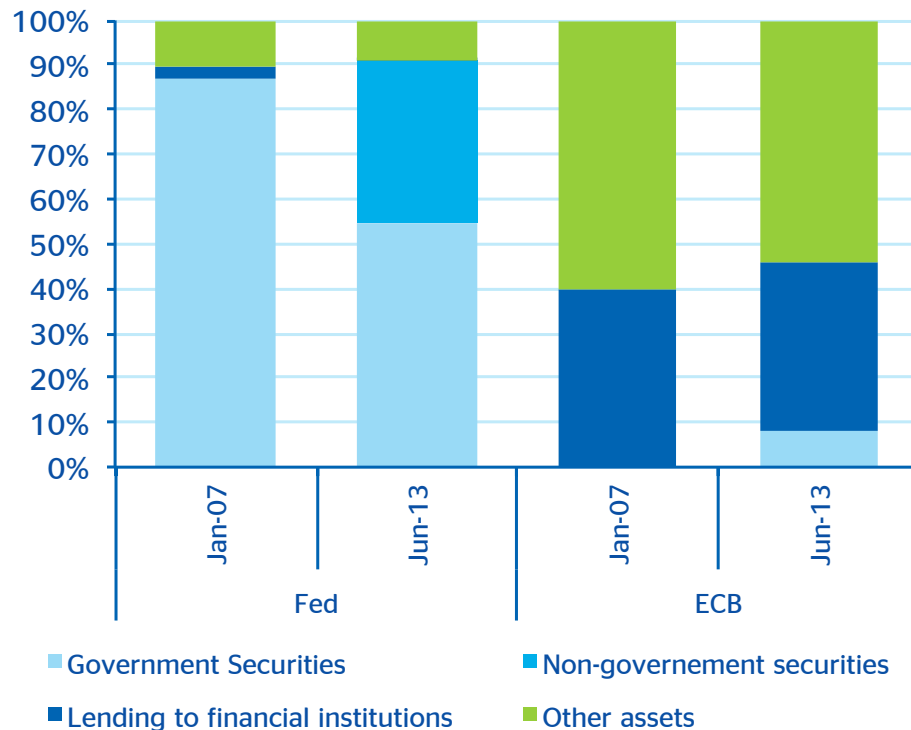
2. Timing: the Fed was more aggressive in 2008-9 whereas the ECB was more aggressive in response to the sovereign debt crisis

5. Monetary policy

... differences in the composition of assets and maturities, ...

Composition of central banks balance sheets by type of asset

Source: Bloomberg and BBVA Research



3. The composition of central banks balance sheets is quite different:

The ECB has solved the liquidity problems of financial institutions

The Fed has been much more active buying public debt and affecting the slope of the yield curve

5. Monetary policy

... and differences in the forward guidance

The dual mandate (inflation and activity) of the Fed makes forward guidance potentially more successful than in the case of the ECB

The Fed introduced two thresholds for forward guidance: inflation below 2.5% and unemployment rate above 6.5%

Despite its previous non-commitment policy, the ECB introduced a softer version of forward guidance in July, 2013:
low interest rates for an extended period of time

Although it would be very informative, the ECB cannot introduce a threshold in terms of the unemployment rate

5. Monetary policy

The ECB as a bridge towards a more genuine EMU

OMT program
of sovereign bond
purchases:

a sizeable
“announcement effect”

- Only after official request of support to ESM
- Conditionality required

- Unlimited purchases of sovereign in secondary markets;
- 1-3 year bonds;
- Possibility of ESM to buy in primary market

- Designed to avoid countries losing market access

- ESM renounces to preference status

5. Monetary policy

The ECB as a bridge towards a more genuine EMU

Despite its limitations (objectives and no mutualization of public and private debt), the ECB has been the most efficient European institution, avoiding the break up of euro and the collapse of some peripheral economies

Rate cuts to 0.5% and extension of full allotment until mid-2014.
The economic impact of the rate cut is presumably limited

Downward bias on interest rates, including the possibility of negative deposit rate

Coordinated action with EIB and EC to support credit to SMEs and new collateral discounts for ABS to ease lending in EMU periphery

5. Monetary policy

The ECB as a bridge towards a more genuine EMU

Fiscal union



Banking union



The solution has benefits but also costs

Problem 1: How to distribute the solution costs in the short term between the members?

Problem 2: How to design a time-consistent solution and the conditions to carry it out?*

See Andrés and Doménech (2012b)

(* See Andrés and Doménech (2012b), Buti and Carnot (2012), Henning and Kessler (2012) or Sargent (2012)

6. Financial integration

Banking union (I): the benefits

Banking union helps breaking the loop between banking and sovereign risk

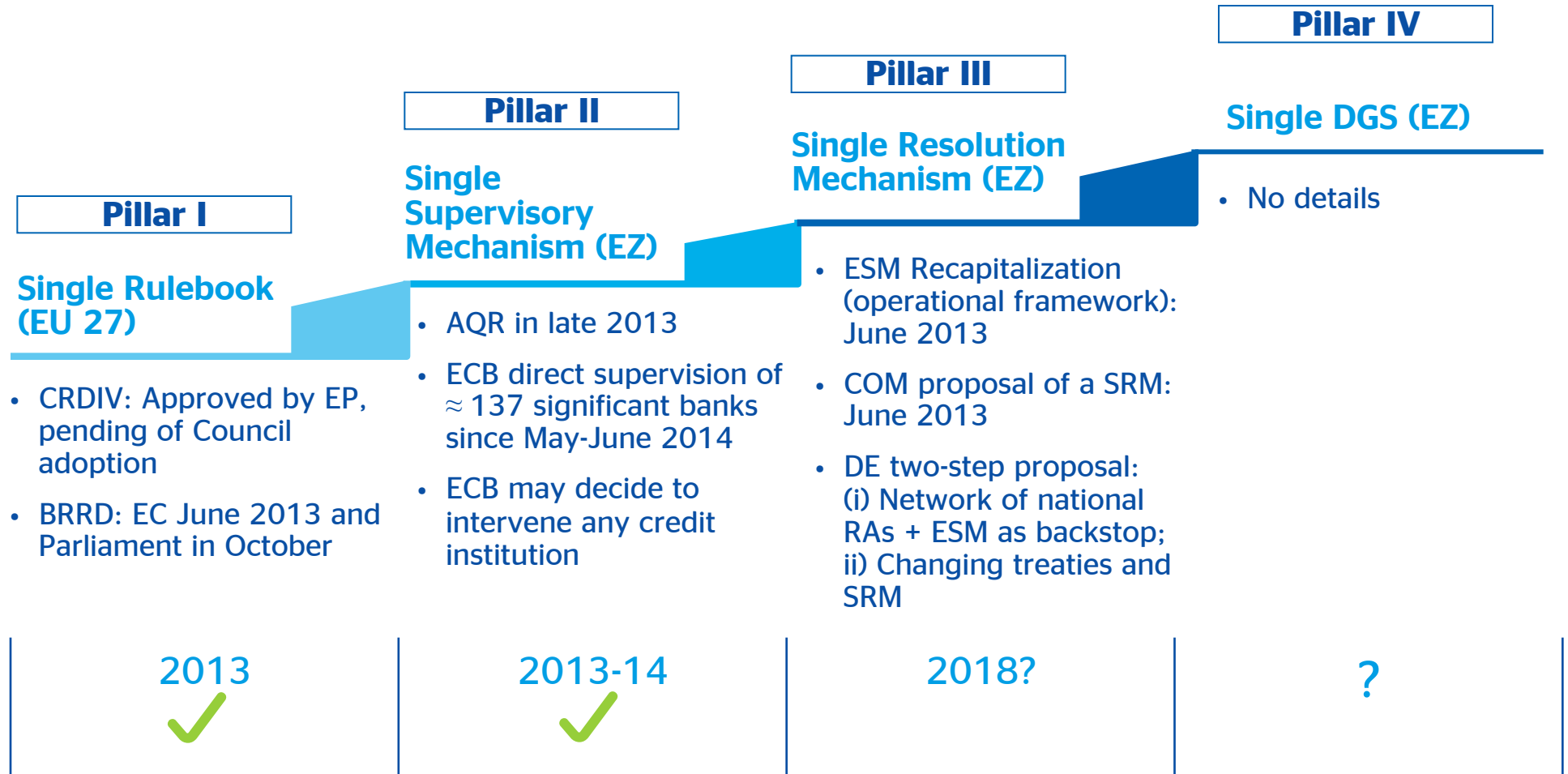
Single Supervisory Mechanism (SSM) reduces banking fragmentation and restores interbank market

The Single Resolution Mechanism (SRM) with participation of the private sector increases incentives to mutualize part of resolution funds

Convergence of financing costs and evolution towards trans-european banks

6. Financial integration

Banking union (II): the initial agenda



6. Financial integration

Banking union (III): the state of the play

The problem lies in the transition: single supervision with national resolution funds

The legal basis is weak.
Eventually, a reform of the Treaty may be needed

The Assets Quality Review should restore confidence on the European banking system, but this may require a sufficiently big backstop

The roadmap shows that the process advances towards a Banking Union, but other changes are needed to decoupling sovereign and banking risks

7. Fiscal integration

Fiscal union has been delayed

State of the play

At the December summit, all focus on banking union.
Progress towards a fiscal union has been delayed

The **Treaty on Stability** and the **Six Pack** appear to be sufficient for now

The key would be an agreement between Germany (accept eurobonds) and France (accept additional EU control of national budgets)

Options for eurobonds

Neither necessary nor sufficient, but convenient as insurance mechanism

1. Blue/red bonds (Delpla and Von Weizsäcker, 2011)
2. Eurobills (mutualize only part of short-term debt)
3. Debt Redemption Fund (Schmidt and Weigert, 2013): Temporary insurance of debt over 60% of GDP

7. Fiscal integration

Six Pack: reinforcing the SGP with macro surveillance

Application

- Approved in December 2011
- Applies to EU27, with some specifics for eurozone on sanctions

Fiscal side:
Strengthening the SGP

Reinforcing the Excessive Deficit Procedure (EDP):

- It defines what is a “**significant deviation**” of budget balance from medium-term objective or its adjustment towards it
- **Launches an EDP** when debt ratio does not diminish towards 60% at a satisfactory pace (not only when deficit is above 3% as was the case so far)
- **Sanctions** by the Commission adopted by the Council unless a qualified majority (QM) of countries are against it. Until now a QM was needed to approve sanctions

Other macroeconomic
imbalances

- **Macroeconomic Imbalance Procedure:** Extends surveillance to other imbalances of the private sector and the external accounts
- **European Semester:** The aim is to identify imbalances earlier on (roughly from January to June) to end up with recommendations on budget and structural reforms to be incorporated in budgetary process in the fall

7. Fiscal integration

Six Pack: reinforcing the SGP with macro surveillance

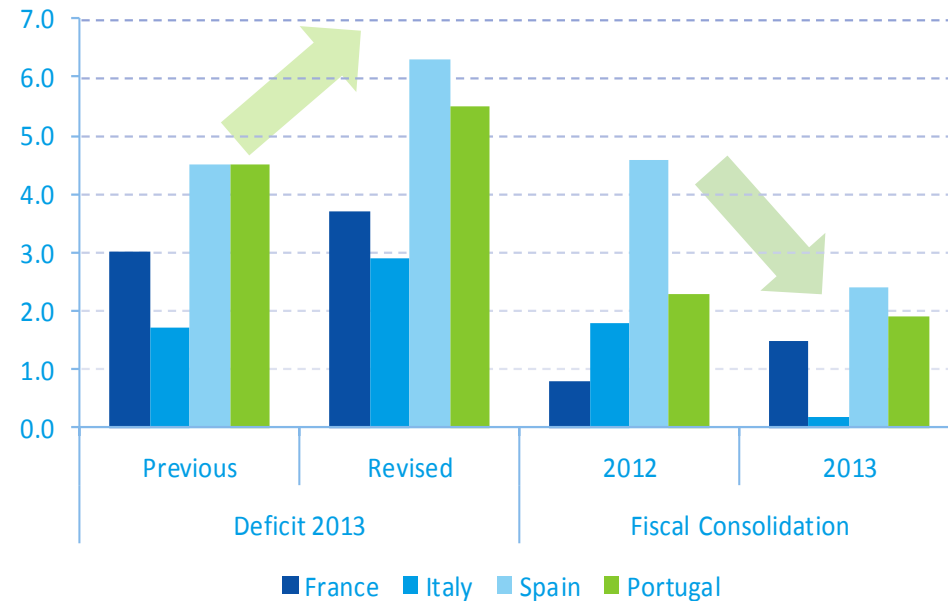
External imbalances	Current account balance (% GDP, 3-year moving avg)	-4% to +6%
	Net international investment position (% GDP)	> -35%
Competitiveness	Export market shares (5 year % change)	>-6%
	Nominal unit labour cost in value (3 year % change)	<9%
	Real effective exchange rate, CPI based (3 year % change)	+/- 5%
Private sector imbalances	Private sector debt (% GDP)	<160%
	Private sector credit flow (% GDP)	<15%
Other	Real house prices, consumption deflator based (growth)	<6%
	General government sector debt (% GDP)	<60%
	Unemployment rate (3 year moving average)	<10%

7. Fiscal integration

In the meantime, fiscal consolidation at a slower pace

Deficit revision and fiscal consolidation

Source: BBVA Research



Fiscal adjustment focus on the structural deficit, instead of the nominal deficit

Hence, no further measures to offset fiscal slippages due to cyclical factors

Lower fiscal adjustment in the eurozone in 2013 (0,6% GDP after 1.3% in 2012)

8. Economic integration

Heterogeneity of structural determinants of growth ...

Structural factors in developed economies, 2010

Source: IMF and BBVA Research

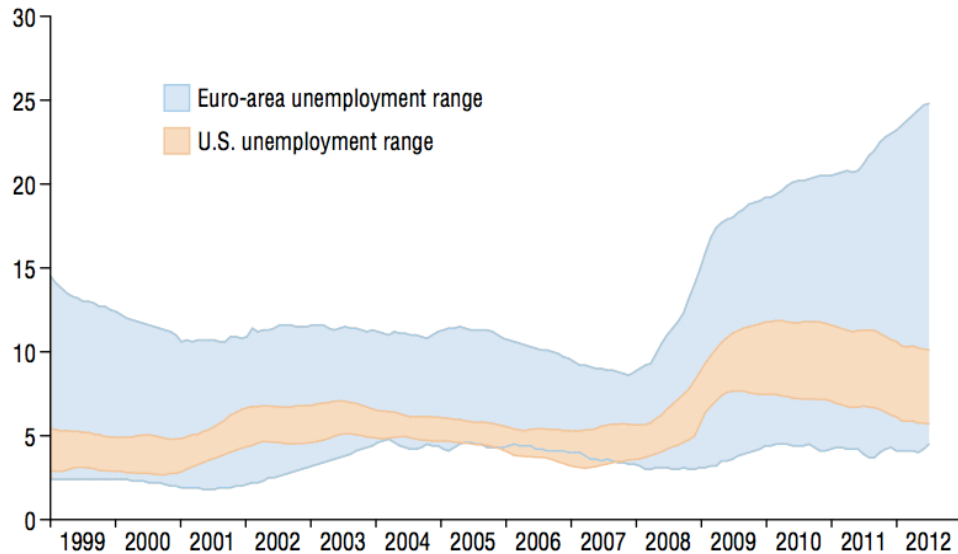
	Liberal Market Economies			Coordinated Market Economies									Mixed market Economies				Avge.
	UK	USA	IRL	GER	FRA	NLD	BEL	AUT	FIN	DEN	SWE	JAP	SPA	ITA	POR	GRE	
Medium Term																	
Labour market	1	1	1	2	3	2	2	2	1	1	2	1	3	3	3	3	1.9
Corporate regulations	1	1	1	2	2	1	3	2	2	1	1	2	3	2	2	3	1.8
Network regulations	1	1	3	1	2	1	1	1	2	1	1	2	1	2	2	3	1.6
Retail regulations	1	1	1	1	2	1	3	3	2	2	1	1	2	2	2	3	1.8
Professional services reg.	1	1	1	3	2	1	2	2	1	1	1	1	2	3	2	3	1.7
Long term																	
Institutions and contracts	1	2	2	1	2	1	2	1	1	1	2	2	2	3	3	3	1.8
Human capital	2	2	1	2	2	1	1	2	1	1	1	1	3	3	3	3	1.8
Infraestructure	1	1	3	1	1	1	2	2	2	1	1	1	1	3	2	3	1.6
Innovation	1	1	2	1	1	1	1	2	2	1	1	1	3	2	3	3	1.6
Average	1.1	1.3	1.7	1.6	1.9	1.1	1.9	1.9	1.6	1.1	1.2	1.3	2.2	2.6	2.4	3.0	1.7

8. Economic integration

... and heterogeneity in unemployment rates

Regional variation in unemployment rates

Source: M. Wynne and J. Koech (2012)



Differences in structural determinants not only result in different GDP per capita ...

... but also in huge differences in unemployment rates across EMU countries ...

The benefits of EMU should go beyond banking and fiscal union: economic convergence

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Conclusions

- Aggregate imbalances and shocks were slightly better in EMU and the USA in 2008 and 2009
- The sovereign debt crisis in EMU was an endogenous shock resulting from European institutions that were not well designed to deal with very heterogeneous internal imbalances and their effects on growth and employment
- Sooner better than later, decoupling sovereign and banking risks requires some sort of debt mutualization (e.g., public debt redemption fund) and a complete banking union
- Structural reforms are needed (1) as an exchange for debt mutualization and (2) to promote economic convergence
- It is crucial to take advantage of the current window of opportunity to ensure economic growth and employment creation, through the implementation of appropriate structural reforms and the improvement of European institutions

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