

Efficient Crisis Prevention in the EU and the Eurozone: Which Macro-economic Imbalances Should Be Addressed?

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Mitigating Socio-economic Heterogeneity in the EU

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Introduction

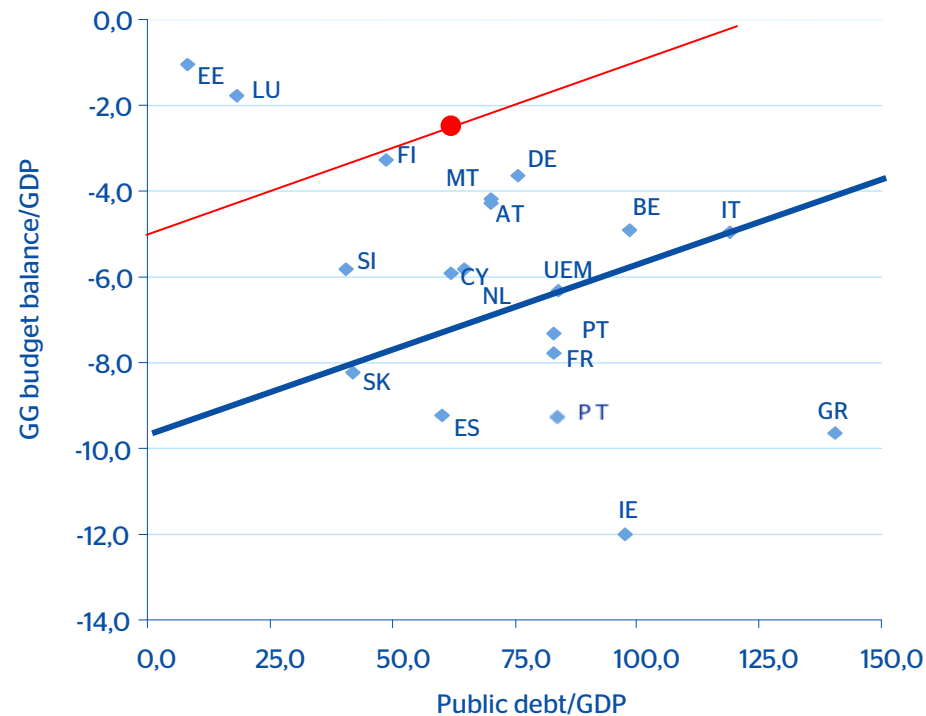
- The **benign neglect approach**: during many years before the crisis, financial markets and policy makers did not care about different imbalances that appeared across markets, sectors and countries in the Eurozone.
- Things are not black and white: as usual in economics, we found arguments against or in favor of some macroeconomic imbalances.
- However, during the expansion period there was a **high degree of complacency** even when indicators were showing that some bubbles were under way.
- **Risk was underpriced.**
- **The (wrong) policy prescription** was that it was better to wait for endogenous (soft) market corrections rather than to attempt to contain the boom.
- The experience during the crisis has shown that corrections **may be not smooth but rather disruptive**: the current welfare cost of the adjustment is enormous for many agents.
- **Lessons for the future**: monitor simultaneously many macroeconomic aggregates and prevent the existence of large imbalances.

Government debts and deficits

- **Debt sustainability.** Assuming nominal potential growth is 4%, then budget deficits above 2.4% give place to public debt levels above 60% of GDP (2,4%/4%)

EU: budget balance and public debt in 2010

Source: BBVA Research abased on AMECO and MEH for Spain



Pension systems face a tough challenge

Public spending in pensions as % of GDP in 2010 and projections up to 2060

Sourc.: Comisión Europea

	Spending 2010	Change between 2010 and 2060				Spending 2060
		Dependency ratio	Employment rate	Coverage ratio	Replacement ratio	
Belgium	10,0	7,4	-0,5	-0,9	-1,3	14,7
Denmark	9,1	6,5	-0,1	-4,9	-1,2	9,2
Germany	10,4	7,9	-0,8	-1,9	-0,3	12,8
Greece	11,7	12,7	-0,6	-0,4	0,7	24,1
Spain	8,4	10,7	-0,9	-0,9	-2,2	15,1
France	13,0	8,4	-0,5	-2,2	-4,7	14,0
Ireland	4,0	5,9	-0,2	-1,5	0,4	8,6
Italy	14,0	10,4	-1,1	-3,2	-6,5	13,6
Luxembourg	8,7	8,4	0,0	5,2	1,5	23,9
Netherlands	6,6	6,6	-0,2	-1,5	-1,0	10,5
Austria	12,8	9,9	-0,5	-2,6	-6,0	13,6
Portugal	11,4	9,8	-0,6	-1,7	-5,4	13,4
Finland	10,0	8,7	-0,6	-3,1	-1,6	13,4
Sweden	9,5	5,6	-0,4	-0,4	-4,9	9,4
UK	6,6	4,2	-0,3	-1,4	0,2	9,3
EU 15	10,2	7,7	-0,6	-1,8	-2,9	12,6

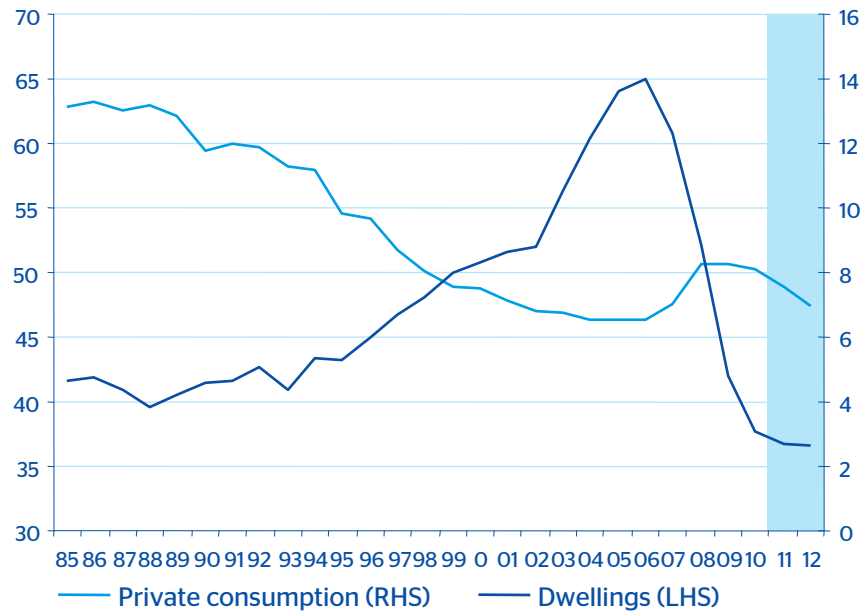
- **Demographic factors:** can make spending to increase in 7 pp of GDP by 2060
- **Institutional factors** could allow to reduce spending by 4.7 pp
- **Specially worrisome in some economies:** Luxemburg (15,2), Greece (12,4), Spain (6,7), Belgium (4,7) o Ireland (6,6) before the reforms.
- After the reform, the **Spanish system is in equilibrium** until 2030. After that year it will need to apply the sustainability factor.

Tax bases for indirect taxes

- In both Spain and Ireland the tax base for dwellings increased strongly during the housing boom

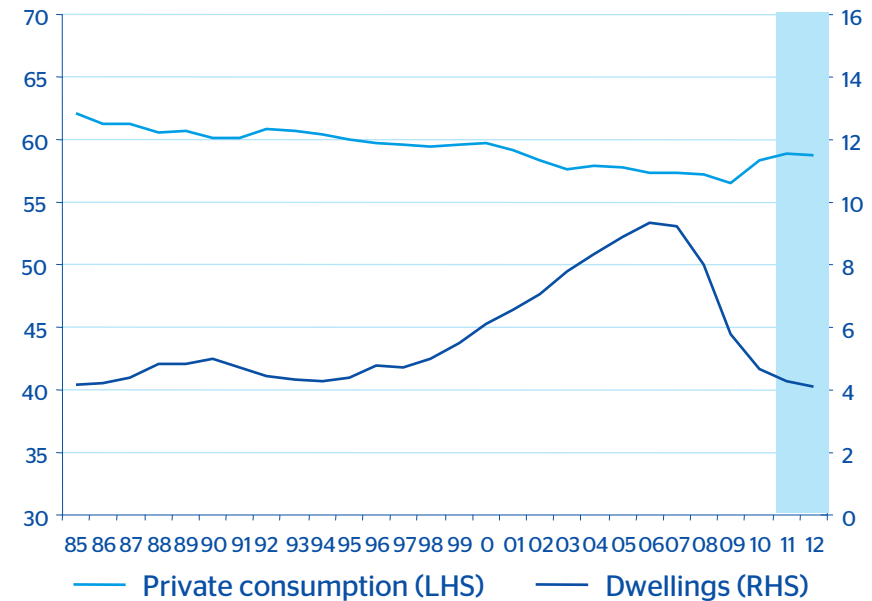
Ireland: Tax base for indirect taxes as % of GDP

Source: AMECO and BBVA Research



Spain: Tax base for indirect taxes as % of GDP

Source: AMECO and BBVA Research



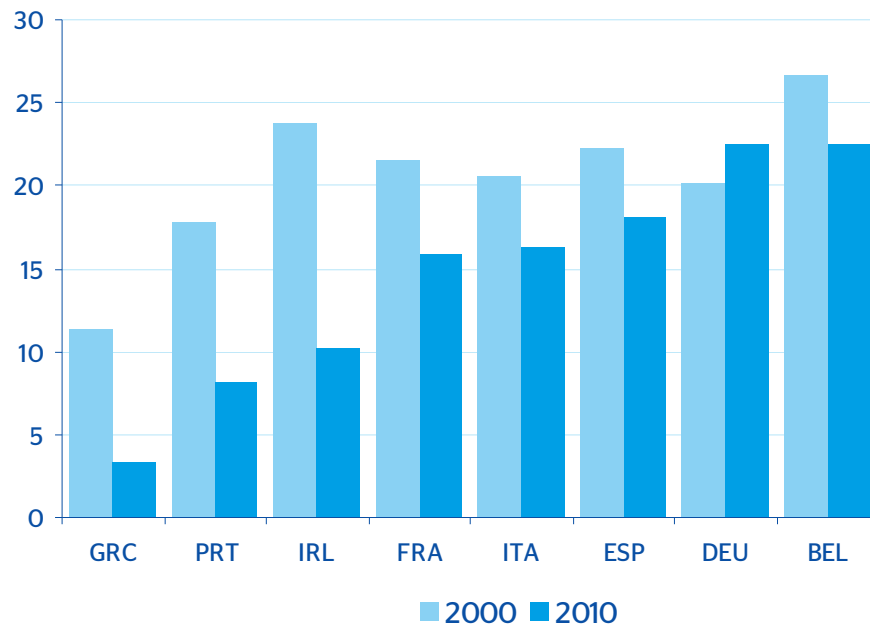


Current account deficits

- Current accounts deficits have different explanations across countries: low savings vs high investment rates.

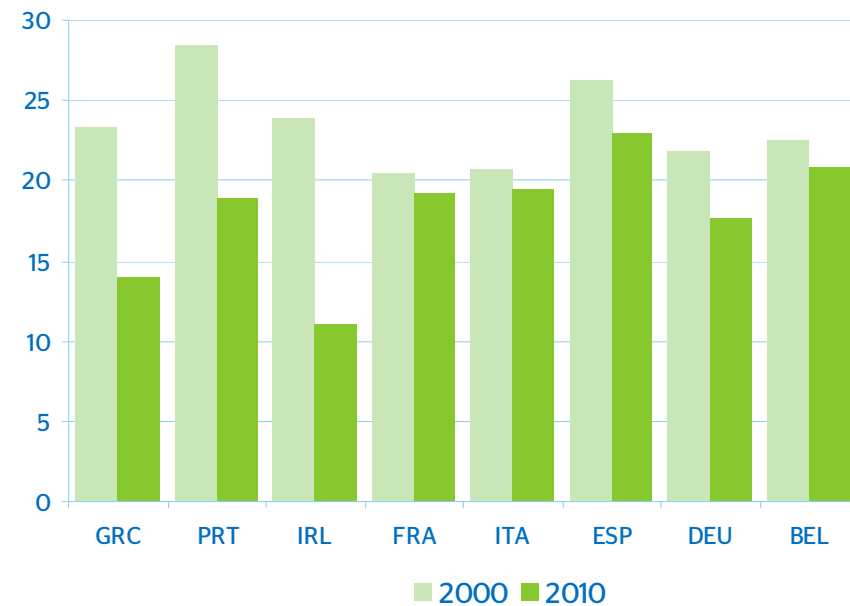
EMU Savings rate (% of GDP)

Source: AMECO and BBVA Research,



EMU Investment rate (% of GDP)

Source: AMECO and BBVA Research,

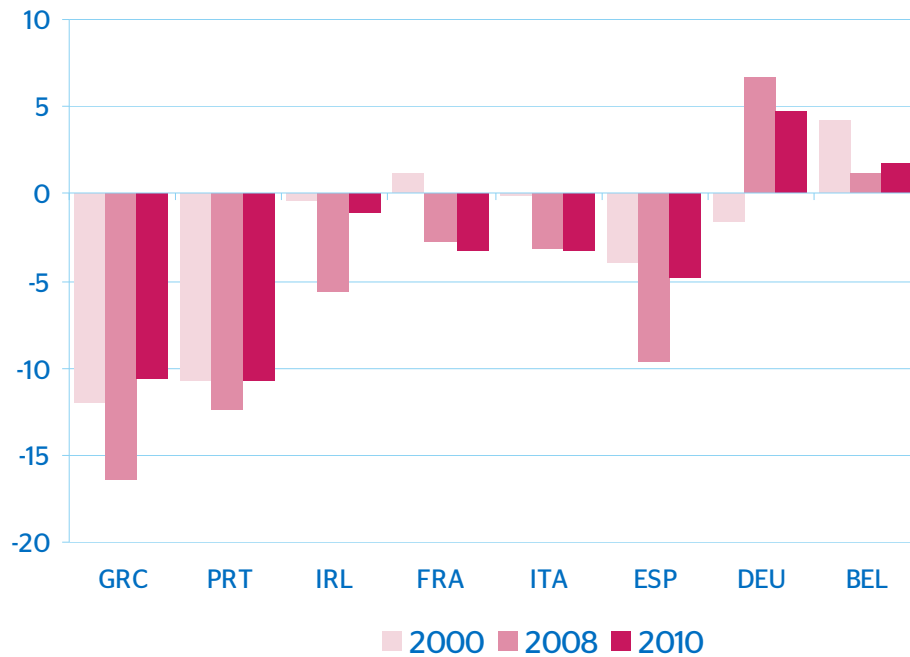


Current account deficits

- Current accounts deficits are correlated with housing booms across the OECD.

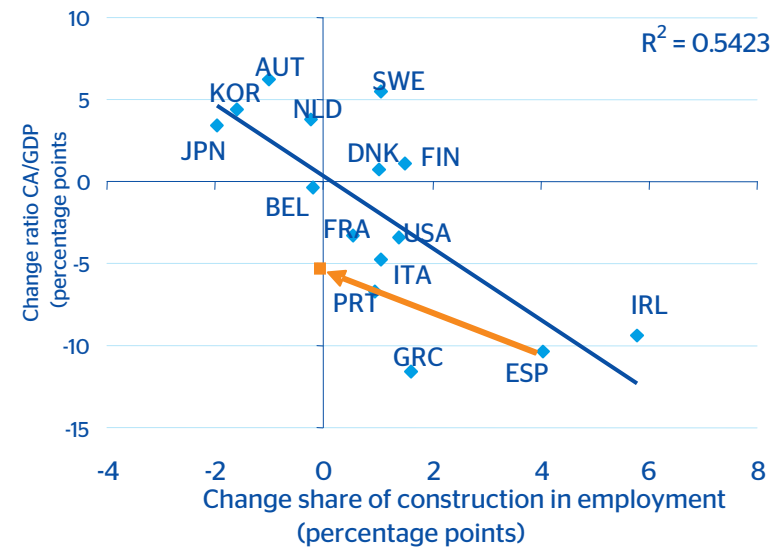
EMU Current account (% of GDP)

Source: AMECO and BBVA Research,



Share of construction in employment and current account balance: 1996-2007

Source: AMECO and BBVA Research

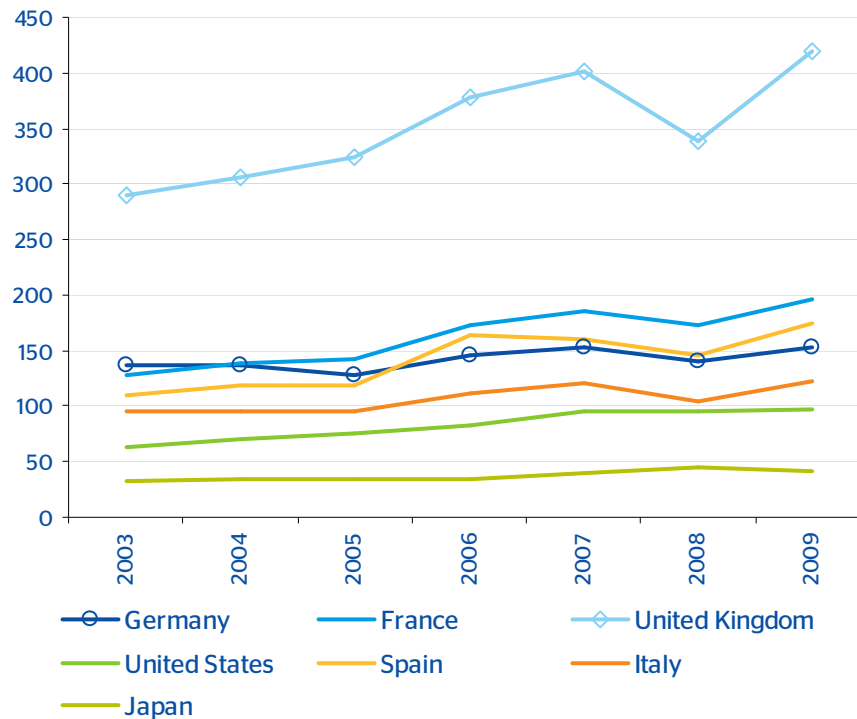


External debt

- Financing needs are also affected by external debt.

External debt (% of GDP)

Source: BBVA Research based on joint data base IMF, WB and BIS and WEO

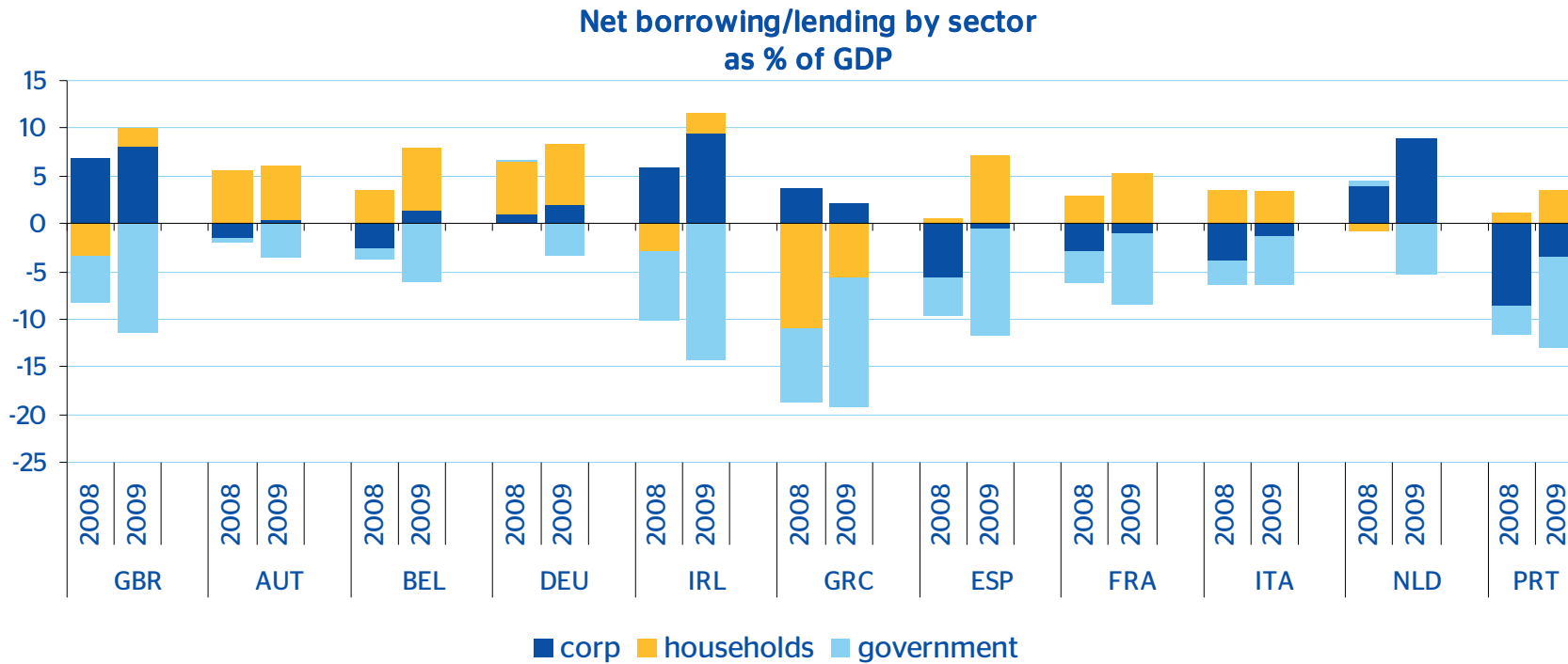


Source: BBVA Research based on joint data base IMF, WB and BIS and WEO



Private sector imbalances

- The composition of financing needs across agents is also relevant in order to assess aggregate imbalances.

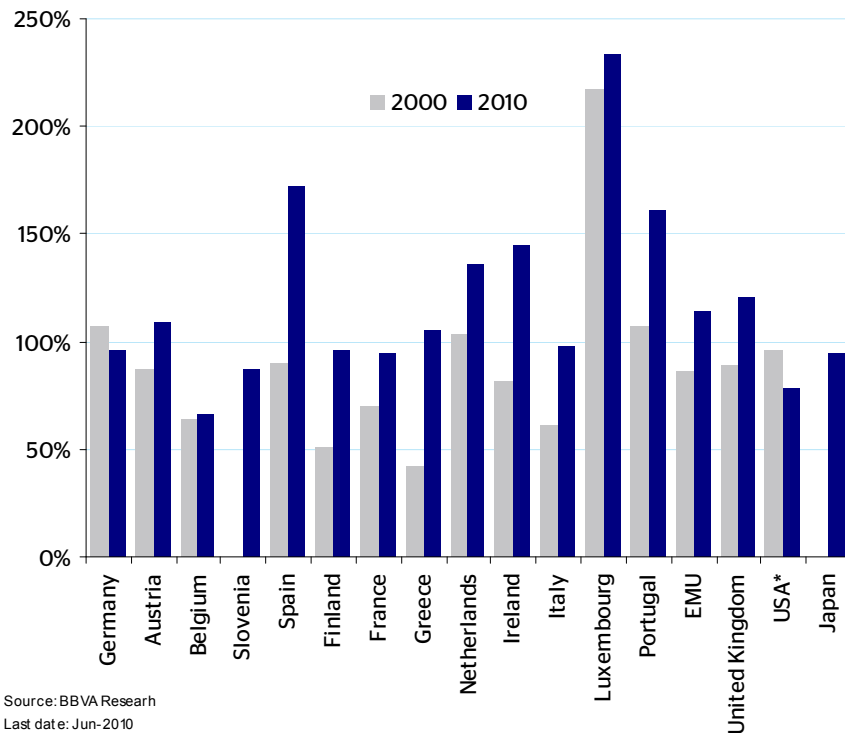


Credit growth and liquidity gap

- Credit growth: financial institutions intermediate the financing needs of different agents.
- ECB liquidity dependence is a measure of financial tensions, when markets are closed. Also look at the solvency of financial institutions (stress tests).

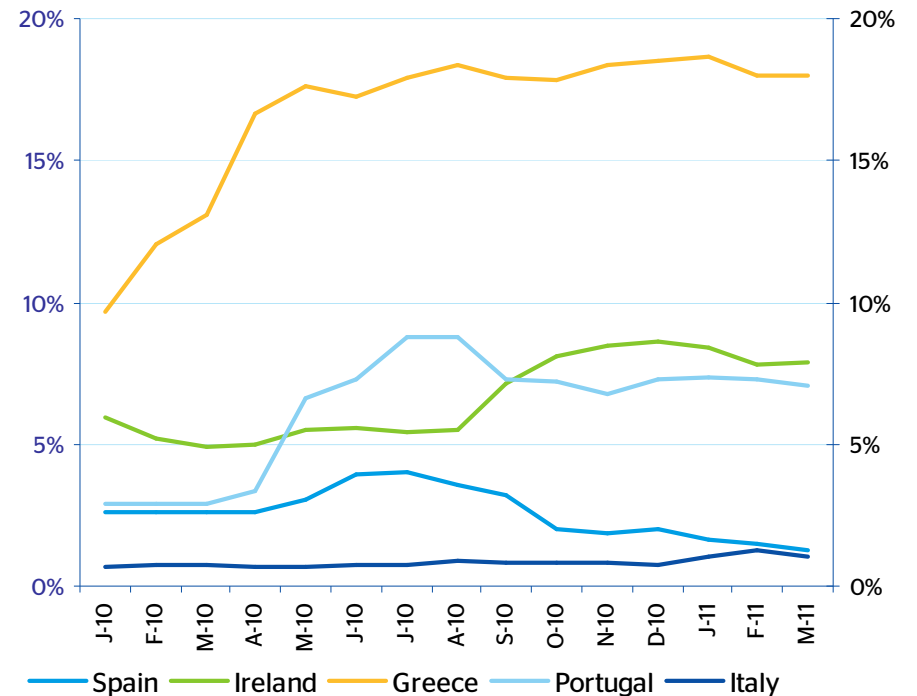
Total credit (% of GDP)

Source: BBVA Research based on ECB



Source: BBVA Research
Last date: Jun-2010
*USA: Mar-2010

Euro area banks: % of total assets funded by ECB liquidity

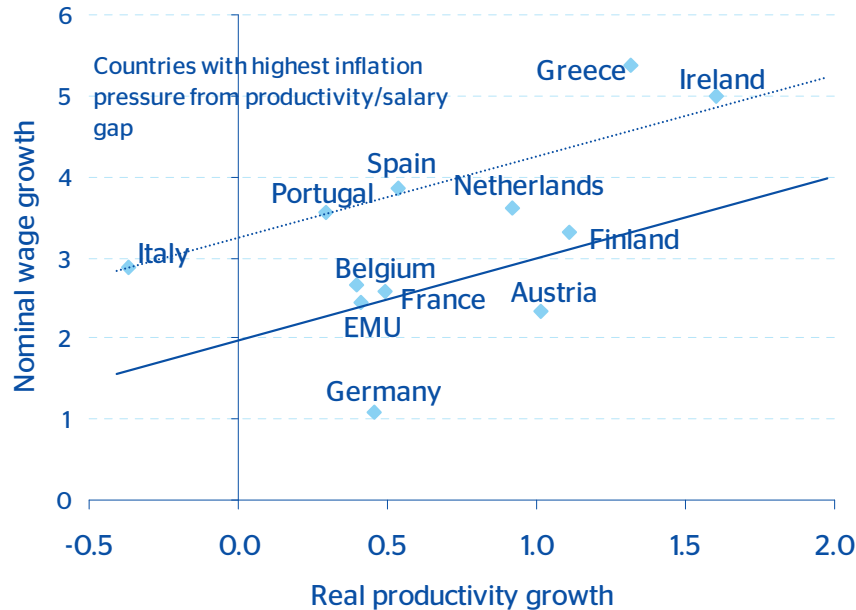


Wage growth and inflation differentials

- Decomposition of inflation differential is also very informative.
- Supply (e.g., Balassa-Samuelson effects) vs demand shocks.

Growth gap between wages and productivity per employee, annual average 2000-2009 (%)

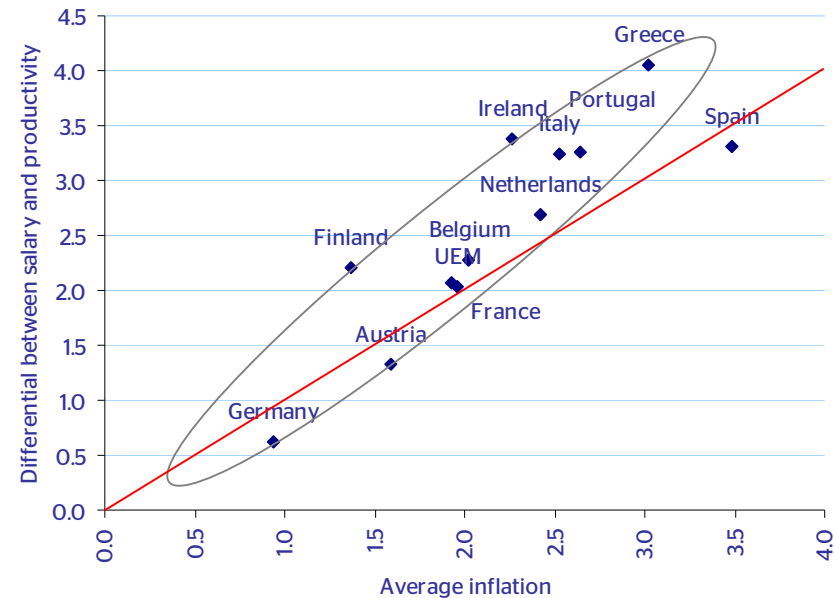
Source: BBVA Research based on AMECO data



Growth differential between salary and employee productivity against avg. Inflation

Annual avg 2000-2008 (in pp)

Source: BBVA Research based on AMECO



Note: productivity is computed as the GDP divided by # of employees (full-time when data is available). UEM data refers to EZ-12.

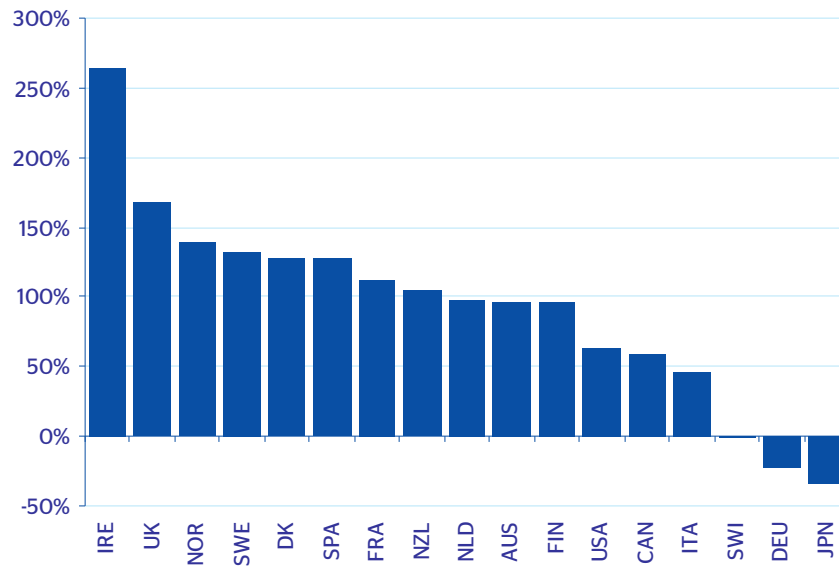


Asset bubbles

- Housing booms are only an example of asset bubbles, which may affect financial and economic stability.
- Look at different indicators: price-to-rent ratios, debt burden, investment rate, etc.

Real housing prices (growth from 1995 to peak*)

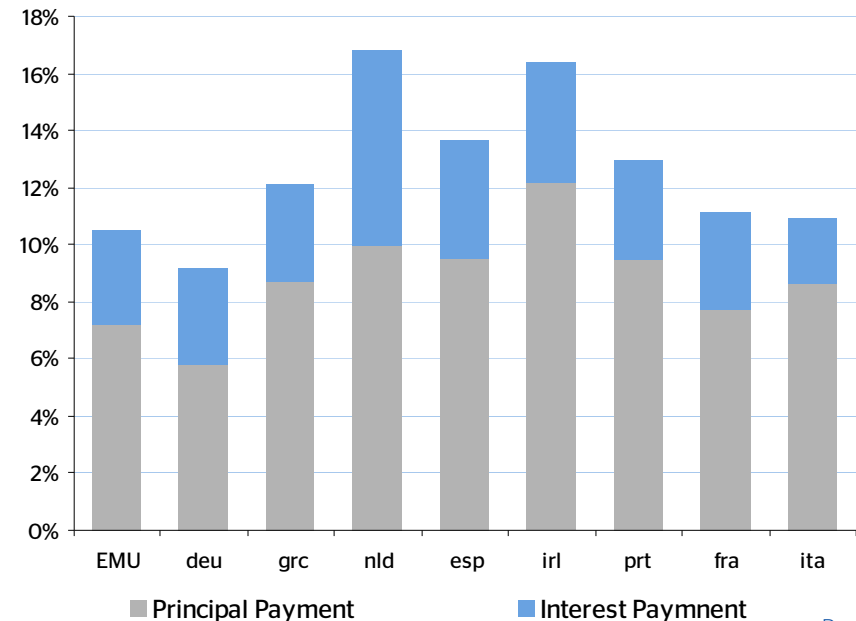
Source: OECD and BBVA Research,



* Note: The peak is reached in 2007 except in IRE and USA where it is reached in 2006

Household debt burden (2010)

Source: Eurostat and BBVA Research,



Economic policy implications

- There exists a **high degree of heterogeneity** across Eurozone members: countries have different problems that make **difficult to prescribe a unique policy**
- An **overall assessment of macro-economic variables** is needed
- Imbalances are usually correlated across sectors, agents and markets. Therefore, a **general and comprehensive analysis**, rather than a partial one, is needed.
- In the past there was a **high degree of complacency** even when indicators were showing that imbalances were under way, as the policy prescription was that it was better to wait for the bust rather than to attempt to contain the boom
- **More cautious approach** to potential imbalances is needed in the future, analyzing the **effects under risk scenarios**.

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