Is Europe condemned to slow growth?

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Big Trends

- China rise not necessarily threat to absolute incomes in EU (any more than growth in Ukraine) BUT
  - Global imbalances a big danger
  - Resources, global warming and terms of trade issues
- Ageing: can be addressed by working longer
- Macro policy issues may kill "liberal consensus"

Ageing?

"All the predicted problems in financing pension and health schemes that result from a rising old-age dependency ratio could be avoided. All that would be required would be to remove the public policy and private incentives that at present induce people to give up work sooner than they might freely choose to do."

http://www.nomura.com/resources/europe/pdfs/TheBusinessOfAgeing.pdf

China?

- Development of China and India may reduce our relative incomes but not necessarily absolute - import prices fall but:
  - China’s current account surplus makes deflationary pressure – their growth is unsustainable
  - Terms of trade matter
    - As wages and prices rise in China the competitive pressure and the consumer bonus fade so we gain less
    - We may see our terms of trade worsen if China enters “our markets”
    - Environmental pressure via demand for raw materials and raw material prices and climate change

Socio-economic pressures

- Society may blame “liberalisation” for rising unemployment and inequality creating opposition to (for example) extending Int Mkt in services
- Budgetary tightening may prevent necessary social adjustment measures
- Fiscal consolidation and private retrenchment likely to slow growth seriously
- See Consequences of the new EU debt-reduction rule **Gianluca Cafiso, Roberto Cellini**, voxeu 3 November 2011

Euro crisis due to Current a/c imbalances

- German surpluses = rest of EZ deficits
- Low ECB interest rates
- Greece exceptional
- To much lending to *private* sector in deficit Eurozone to consumers and property sector leading to cost inflation
- Massive current account deficits opened up which were *temporarily* easy to finance privately .
- But when this dried up EZ had no mechanism for lender of last resort, fiscal solidarity or devaluation
- General austerity self defeating

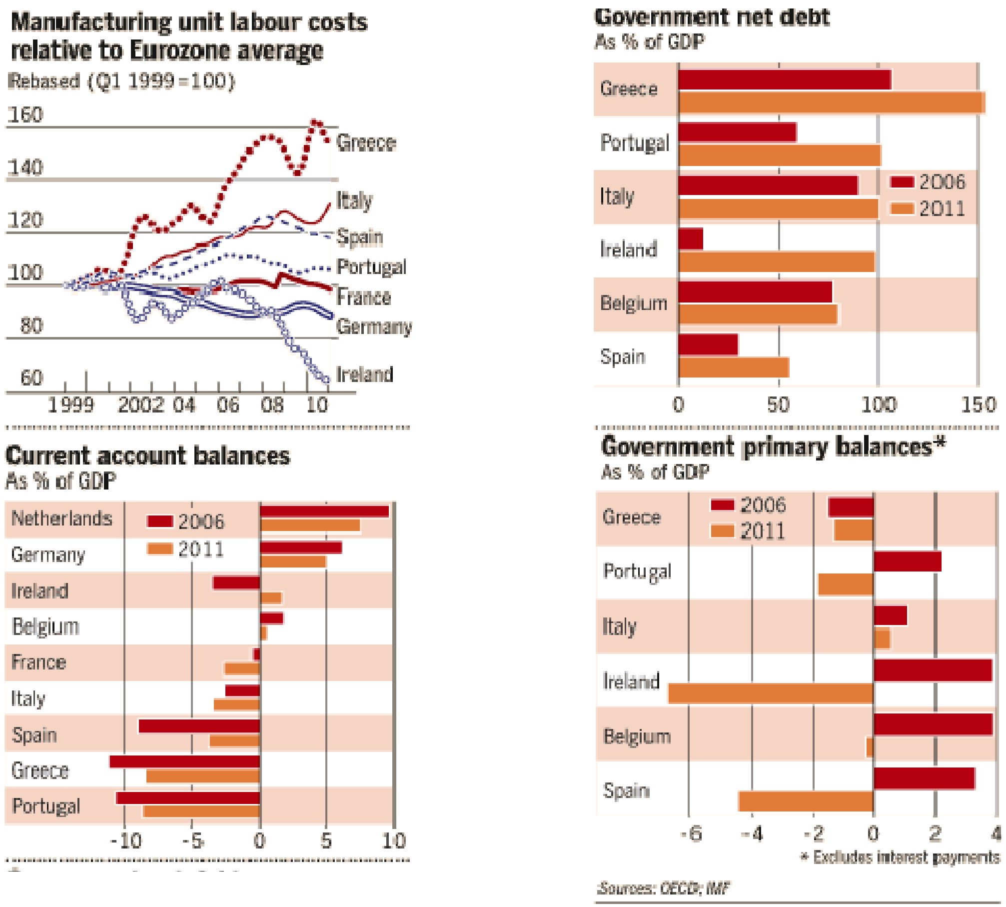
Current account deficits caused the crisis not government debt (exc Greece) Moral hazard?

http://wallstreetpit.com/84251-what-really-caused-the-eurozone-crisis-part-1

Fiscal balance		CA balance	
Country	2000-07 ave	Country	2000-07 ave
Greece	-5.4%	Portugal	-9.4%
Portugal	-3.7%	Greece	-8.4%
Italy	-2.9%	Spain	-5.8%
France	-2.7%	Ireland	-1.8%
Germany	-2.2%	Italy	-1.3%
Austria	-1.6%	France	0.4%
Netherlands	-0.6%	Austria	1.6%
Belgium	-0.4%	Belgium	3.0%
Spain	0.3%	Germany	3.2%
Ireland	1.5%	Netherlands	5.4%
Luxembourg	2.3%	Finland	5.9%
Finland	4.1%	Luxembourg	10.6%

Competitiveness and imbalances

M.Wolf FT Oct 5th 2011



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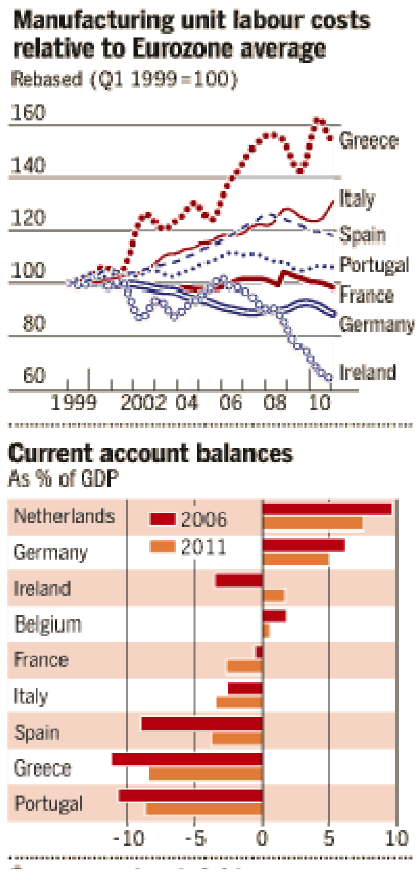


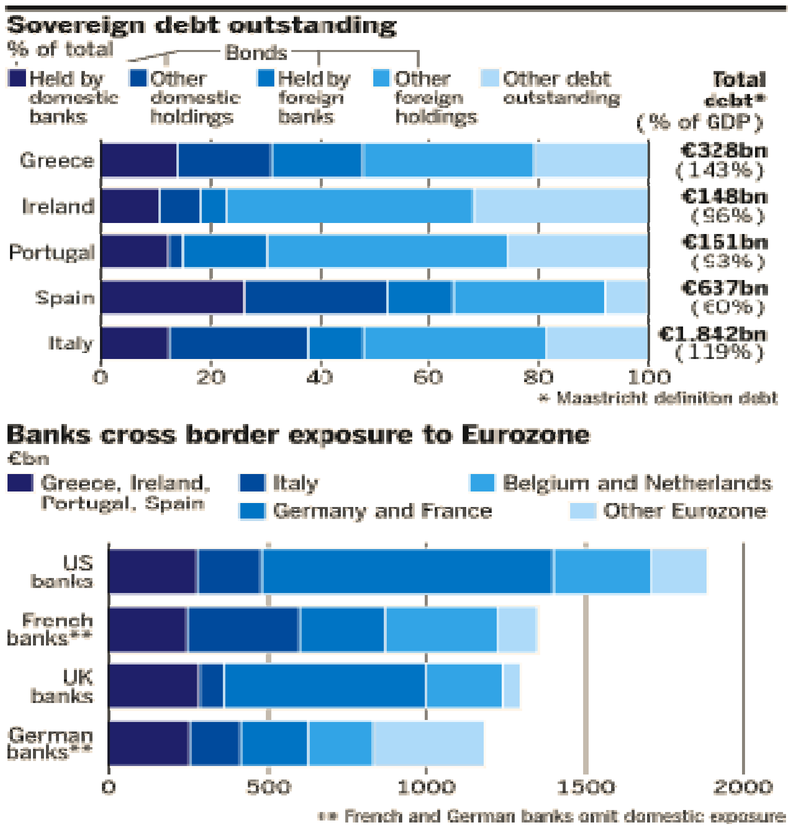
Austerity alone cannot work
"Painful Medicine" IMF

http://www.imf.org/external/pubs/ft/fandd/2011/09/ball.htm

- Self reinforcing deflationary spiral will be triggered if all try to reduce spending at once unless there are *unprecedented* changes in relative prices or wages.
- Deficit states cannot all simultaneously unless Germany (or China et al !) reduce their trade surpluses.
- Credit crunch in South and East will hit northern banks and economies
- Unrest and loss of confidence will damage investment
- Slow growth spooking markets and raising rates

Uk ,Germany, France Banks $250BN each exposure

Martin Wolf charts FT Sept 20th



Would credible bond guarantees cost more than allowing bank contagion?

J Weidman: "*Again, the crucial point is that the eurosystem is not permitted to lend to eurozone member states – no matter whether this is done directly or indirectly by using the IMF as an intermediary*." FT Nov 14th 2011

But

ECB does buy 2nd hand bonds

"five members of the 'German Council of Economic Experts', propose[ ] a novel solution to the crisis – the European Redemption Pact and an associated European Redemption Fund. This would – like Eurobonds – create a joint debt vehicle, but unlike Eurobonds it would be temporary, say 25 years"

Peter Bofinger Lars P Feld Wolfgang Franz Christoph M Schmidt Beatrice Weder di Mauro http://www.voxeu.org/index.php?q=node/7253 Nov 9 2011

W.Buiter says EFSF should become a bank and ECB lend to it

Eichengreen says CB's regularly exceeded their mandate when needed.

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Export led growth is no longer an option, nor is import (current a/s deficit) led!

- Export led growth, for Germany, China etc relies on an importer willing to borrow and eventually able to repay.
- Global and EZ imbalances are parallel
- Current accounts matter in Eurozone
- Asymmetric Fiscal federalism not a solution if only tool is deflationary pressure on net importers

Any politically acceptable way ahead?

- Only solution is willingness to underwrite *stocks* of non-Greek Eurozone bonds. Political and legal obstacles. But many CBs have exceeded mandates in past.
- But *flow* issue would remain even if interest rates fall. Need demand expansion and even relative price increases in Germany
- Fiscal integration would be price of any rescue, but would it come at an unsustainable price. Would conditions for rescue a) work b) be politically sustainable?
- Austerity in “PIIGS” could not restore balance unless Germany moves to deficit or EZ generates a big surplus(with moon?)
- Can deflation really adjust relative prices? (NB Cavallo idea of cuts in employment taxes + rises in VAT)

Was Bernard Connolly right?

- Global imbalances and intra EZ imbalances show unsustainable asymmetries are indeed unsustainable: you can't have *everyone* becoming more competitive and exporting their way our of recession
- Europe and esp EZ does look set be doomed to slow growth *even* in the scenario of an escape from the Euro crisis: *mass* austerity will not rebalance EZ
- South risks internal demand crunch and contagious default – German banks? German Markets?
- Contagion to East
- Condition for fiscal integration might be fatal – and if Greece et all were in primary surplus, default attractive
- ECB as LLR may be bad news but alternative worse
- Political and consequences…..?