GETTING THE EURO ZONE OUT OF THE DOLDRUMS

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The way to stagnation: stylized facts and some theory

Anemic potential growth, perennial output gap and subpar real interest rate

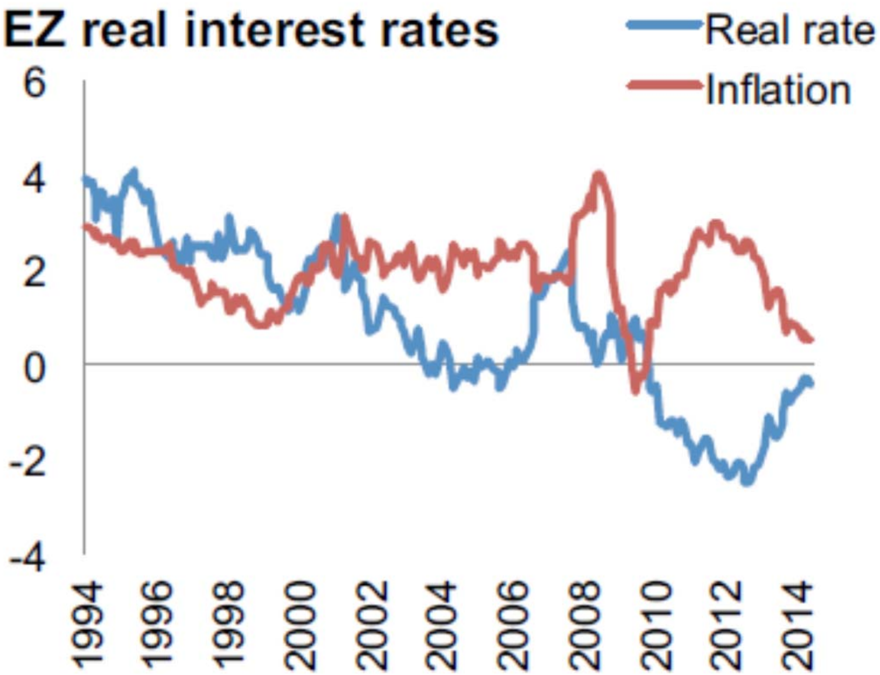
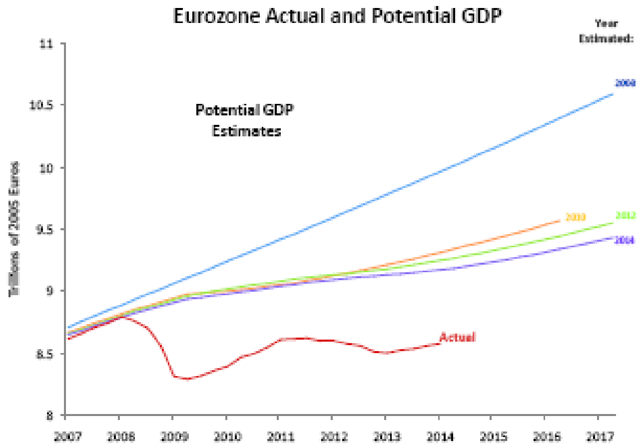


Figure 1b Actual and potential GDP in the Eurozone

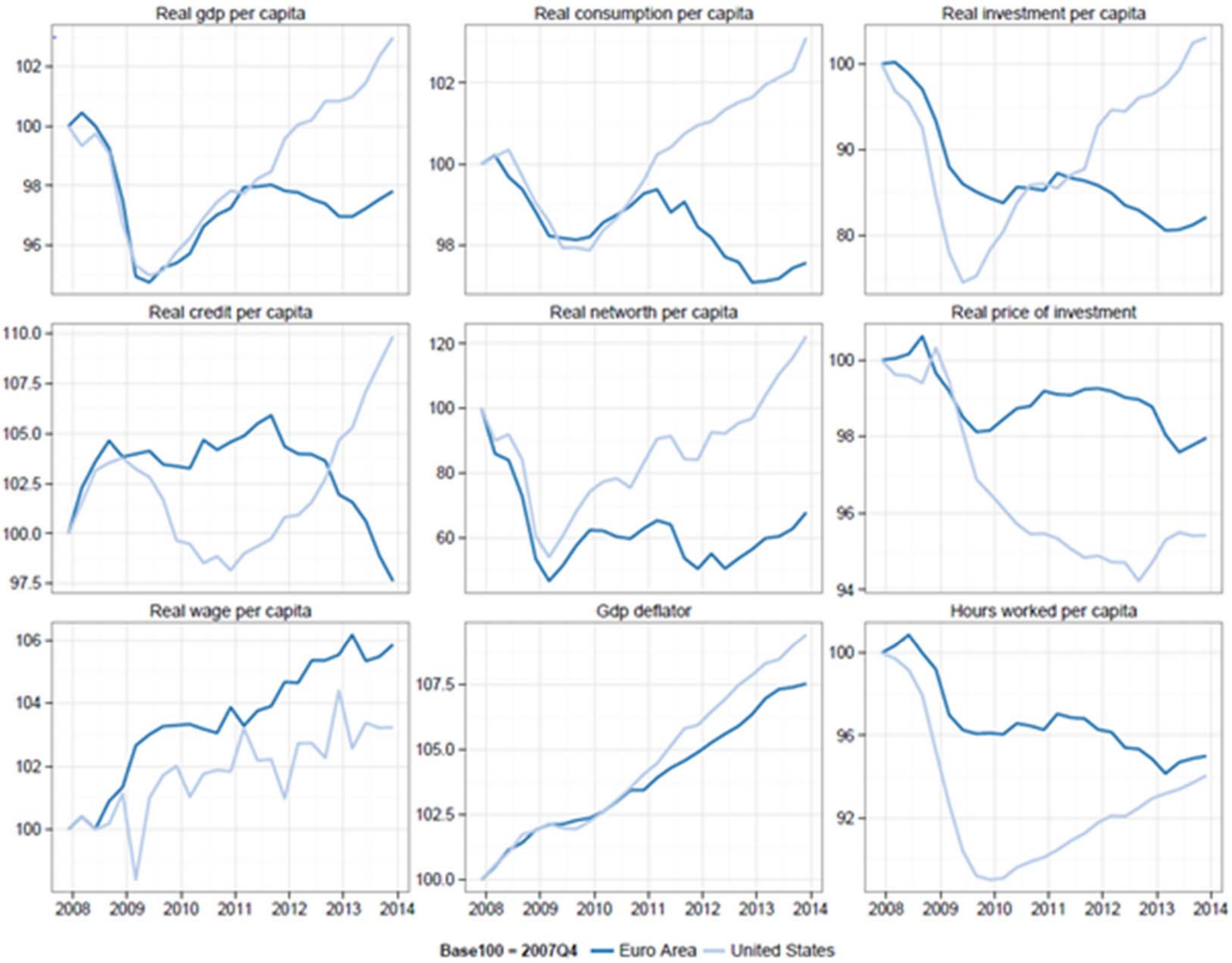


Sources: IMF World Economic Outlook Databases, Bloomberg.

The EA double dip recession was largely self-inflicted

- The financial crisis in 2007-08 impacted the euro zone somewhat less than the US
- In 2009 Europe participated modestly to the global fiscal stimulation drive that was effective to stop the spiraling depression in world trade
- In 2010, 3 major errors of economic policy changed the course of the euro zone:
  - *The cleaning of bank balance sheet was delayed*→ credit paralysis
  - *The Greek crisis was allowed to spread to solvent countries* → vicious circle public debt/ bank net wealth deterioration + money market fragmentation and freezing counterparty trade
  - *Much too fast restrictive fiscal adjustments*→ recession (2011-12) → high multipliers and ↑ in public debt ratios
- In 2013 feeble rebound unable to revive productive investment→ relapse into stagnation in 2014

US/EA: the great divergence



Failure to reduce debt and incomplete adjustment in highly asymmetrical euro zone

National debt variation(% GDP)	Private non-financial	public
	Δ(2008-13)	Δ(2008-13)
US	-19	+22
EA	0	+26
France	+13	+24
Germany	-7	+13
Italy	+6	+21
Spain	-11	+54
UK	-16	+34
Japan	-3	+46

	GDP growth (% average)	Current account balance (%GDP)
	2012-14(f)	2012-14(f)
US	2,4	-2,3
EA	0,0	+2,0
France	0,5	-1,6
Germany	1,1	+7,4
Italy	-1,2	+0,6
Spain	-0,6	+0,3
UK	1,6	-3,9
Japan	1,4	+0,3

The link between impeded debt deflation and low-growth equilibrium

- *Natural interest rate*: equilibrium real rate that balances the market for loanable funds at the level of potential output ≈ rate which optimizes the use of available factor resources at an output level compatible with a stable rate of inflation validating LT expectations.

- *Full employment equilibrium* (NAIRU): natural rate=market real rate= central bank policy rate- inflation rate (when inflation= target)

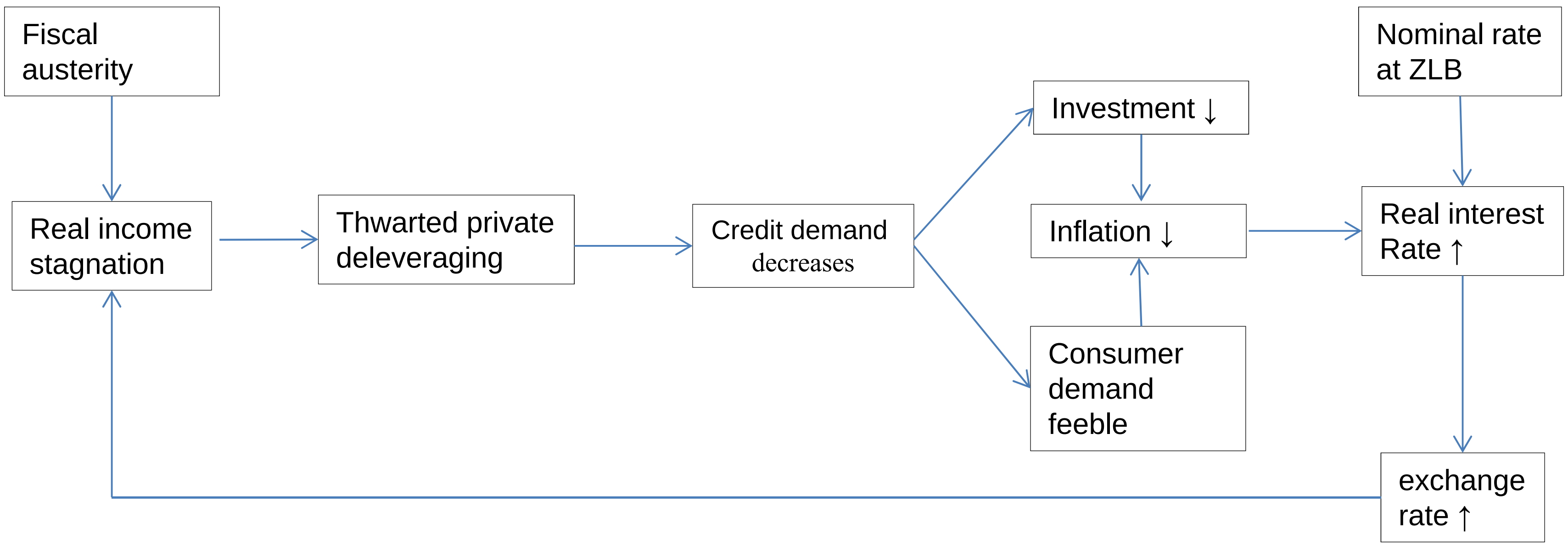
- *Debt deflation*: induced by the downturn in the financial cycle→ widespread asset losses, heavy damages in balance sheets and large debt failures. The longer the losses keep unaccounted and balance sheets unrepaired, the longer-lasting debt deflation

- *Shift to safety*: risky Invest↓ and desired saving↑ drives riskless nominal interest rate ≈0 and inflation rate ↓ well under target

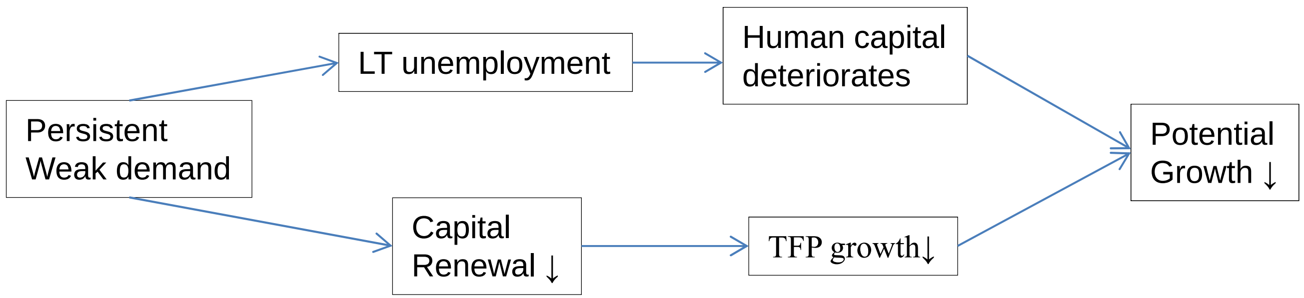
- *Low-growth trap*: equilibrium at GDP level where market rate< natural rate without market adjustment to full-employment equilibrium

The low-growth trap

- Demand side:



- Supply side:



Improving governance and reshuffling growth

Overhauling European finance (1)

- Full banking union is overriding and urgent :
  - According to BIS, NPL ratios ↑ 6 years after financial crisis in several countries→ financial system still fragmented. Full resolution mechanism cannot exist without common backstop→ a *federal resolution agency* to overcome national conflicting prudential prerogatives over transnational banks.
  - Universal banking model must change with post-crisis global trends: a 3-tier specialized banking model (retail/ project and M&A financing/ market arbitrage)

- Enlarged ECB responsibilities must be embodied in a doctrine change:
  - In the ST *lifting inflation* with extensive balance sheet policy to reduce real market rate< natural rate in order to revive productive investment.
  - *Overhauling the Maastricht doctrine and missions of ECB*: acknowledging that ECB has multiple objectives (price and financial stability) that require coop with fiscal policy to provide an *aggregate EA policy mix* contingent to macro situation.
  - Active role of ECB in providing *direct* guarantees to NF firms: new financial instruments (ABS, asset finance) and *indirect* backing by purchase of securities held by non-bank financial intermediaries.

Overhauling European finance (2)

- Stricter prudential ratios and mark-to-market accounting impede banks and institutional investors to take risks if robust risk sharing devices are not at hands

- Because of externalities, irreversibility and non-linear dynamics, market accounting cannot be economically efficient for LT investment:
  - It overvalues market risks in injecting ST market fluctuations into LT assets
  - It biases internal rate of returns of investment projects in ignoring >0 and<0 externalities

- Counting on market finance leads to conservative strategies→ new investment channels and new financing instruments needed to share the risks:
  - *Carbon asset as legal reserve in the monetary system:* central bank buying central bank buying carbon certificates issued by independent agencies validating GHG abatement in low-carbon productive investment valued at European social value of carbon instituted by EC Council
  - *European Investment Fund* (upgrading status and mission of EIB) *capitalized by European budget* (via rebalancing the budget structure towards the function "competitiveness growth") to intermediate responsible LT investors financing in issuing high-quality bonds and coordinating pooling of funds with guarantees to finance invests in new energy mix, energy efficiency and climate change adaptation

Going on with institutional reforms to make fiscal policy more coordinated and responsive to macro environment

- Institutional improvement to improve fiscal coordination from non-credible unilateral commitments to mutual trust in monitoring fiscal adjustment:
  - *Linking together the High Councils of Public Finances* to provide a common independent expertise on hitherto unrecognized externalities due to macro interdependencies in a monetary union.
  - *Improved democracy in the elaboration of the MT stability Programs and correction mechanisms of annual budgets* : Allowing the college of High Councils to report their diagnosis within the European Semester procedure to a conference of representatives of Financial Committees of National Parliaments.

- Introducing a stabilization mechanism against asymmetrical shocks:
  - Impossible to make effective growth-friendly adjustments in deficit countries with the largest country boasting 7.5 to 8% of GDP surplus
  - Introducing a *pure stabilization mechanism through an Insurance Fund* regulating fiscal transfers between EA countries computed on ***relative*** output gaps. The Insurance Fund will be balanced by construction. All countries will have net 0 positions over the business cycle (no redistribution) if output gaps are correctly measured.