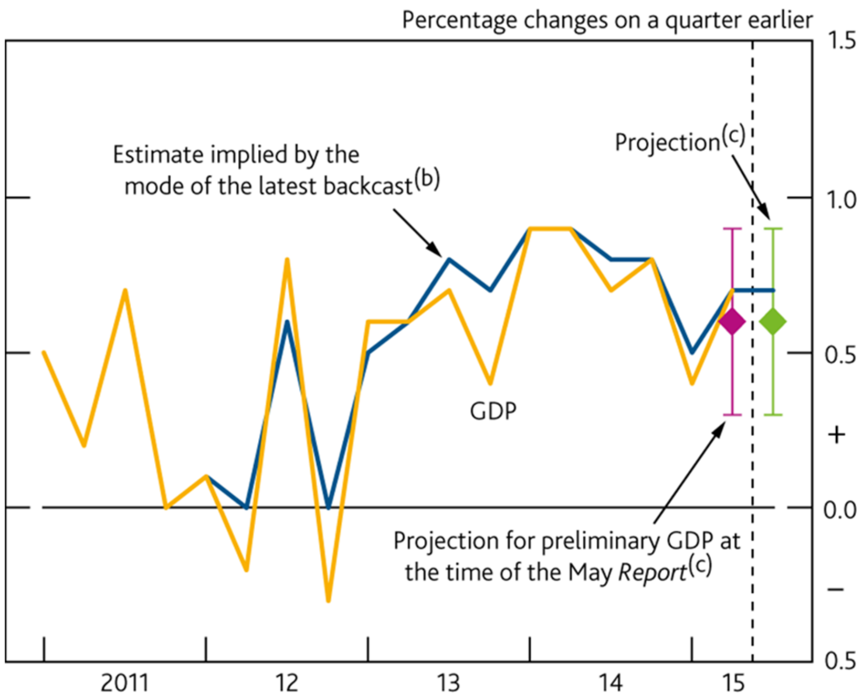
Macroeconomic challenges facing Europe

Charles Bean
London School of Economics
(Formerly Deputy Governor, Bank of England)
Tokyo, September 2015

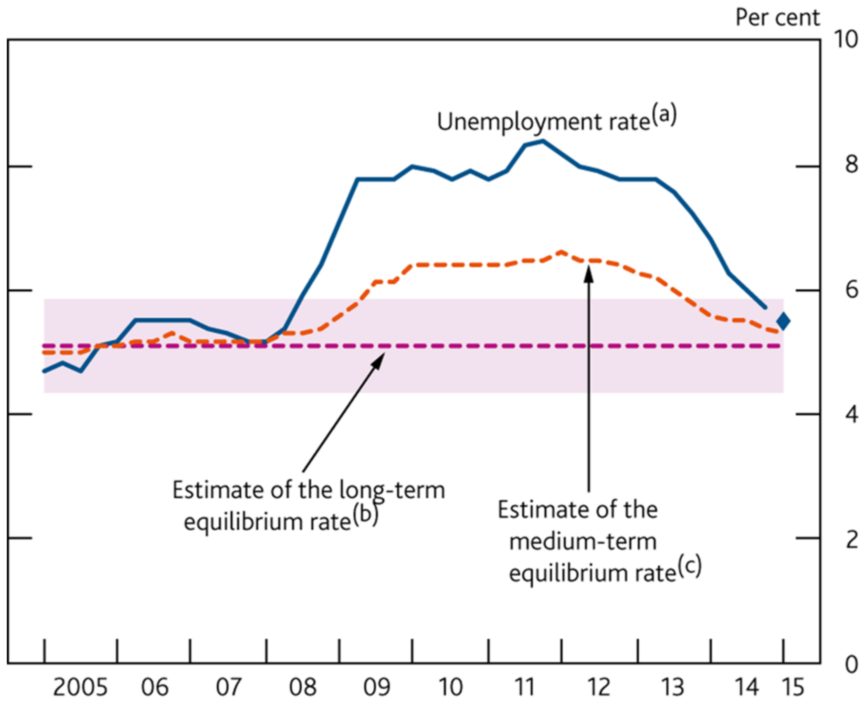
United Kingdom

UK economic activity

GDP growth



Unemployment

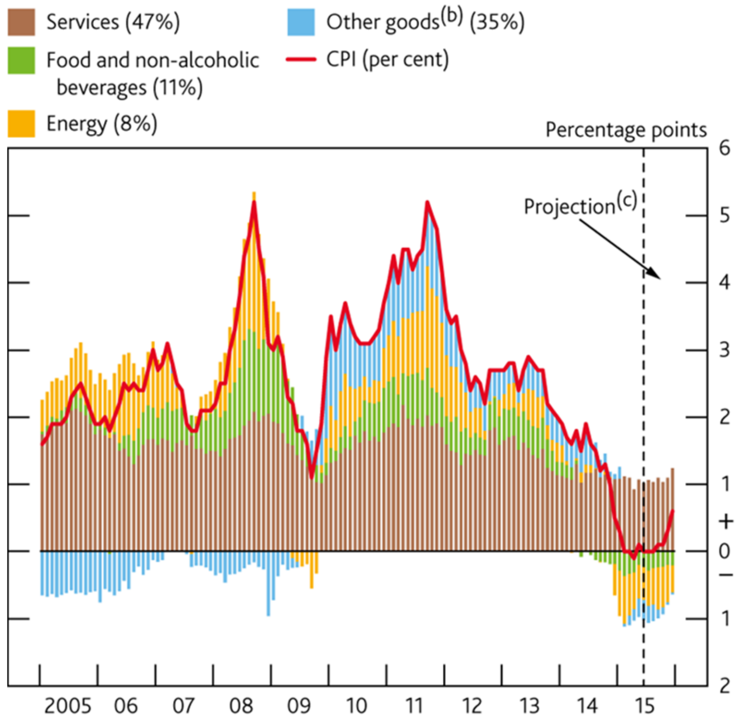


Source: Bank of England

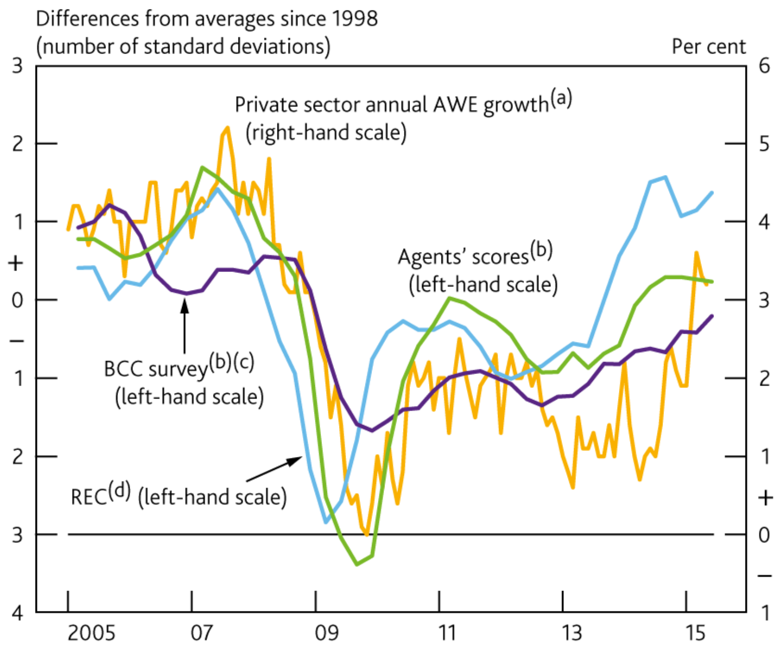
- Quarterly growth of ≈ ¾% for past 2½ years
- Unemployment back near pre-crisis rates

UK prices and costs

Inflation



Earnings indicators

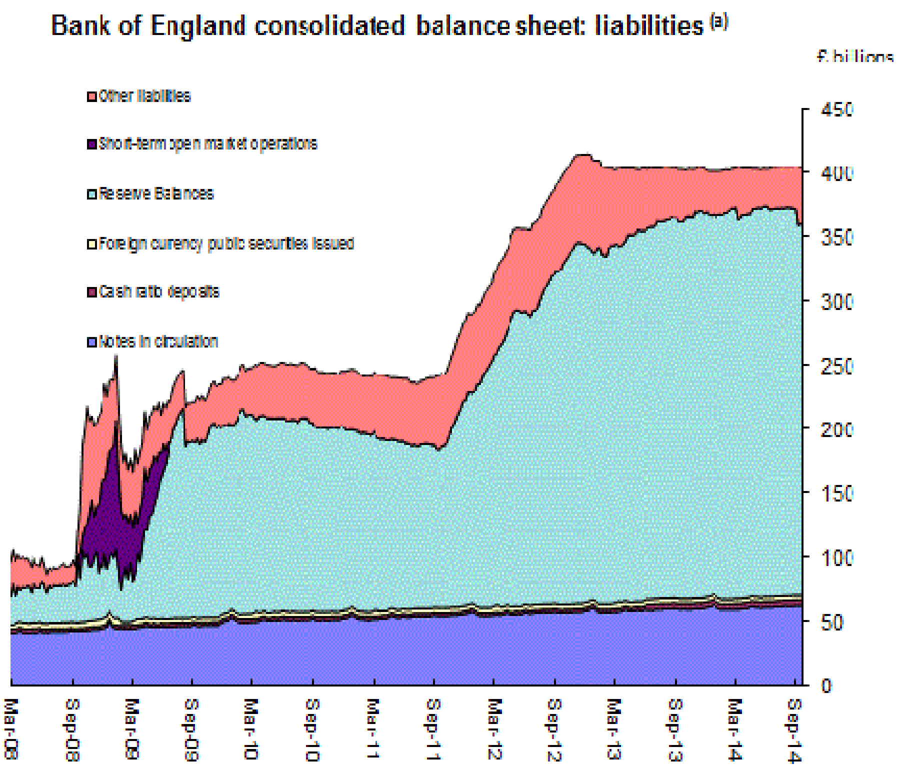


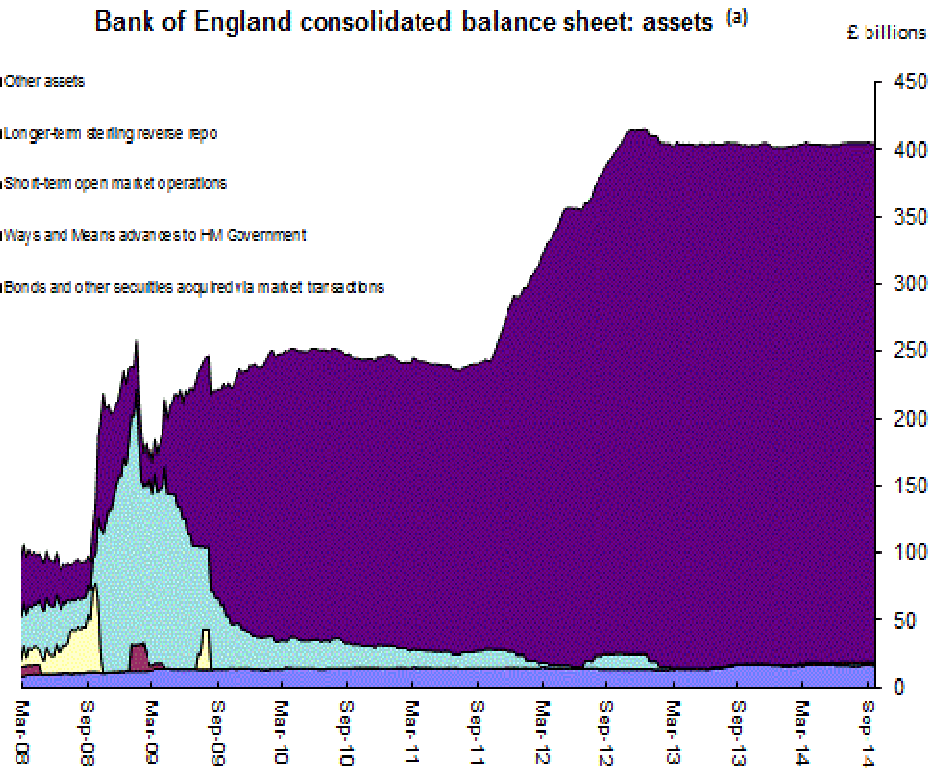
- Inflation temporarily subdued (food, energy, sterling strength)
- Pay growth finally picking up

Key challenges for UK

- Managing the monetary policy exit
- Low productivity growth: Temporary or persistent?
- Imbalances
- “Brexit”

Bank of England Balance Sheet





Asset Purchases: Exit

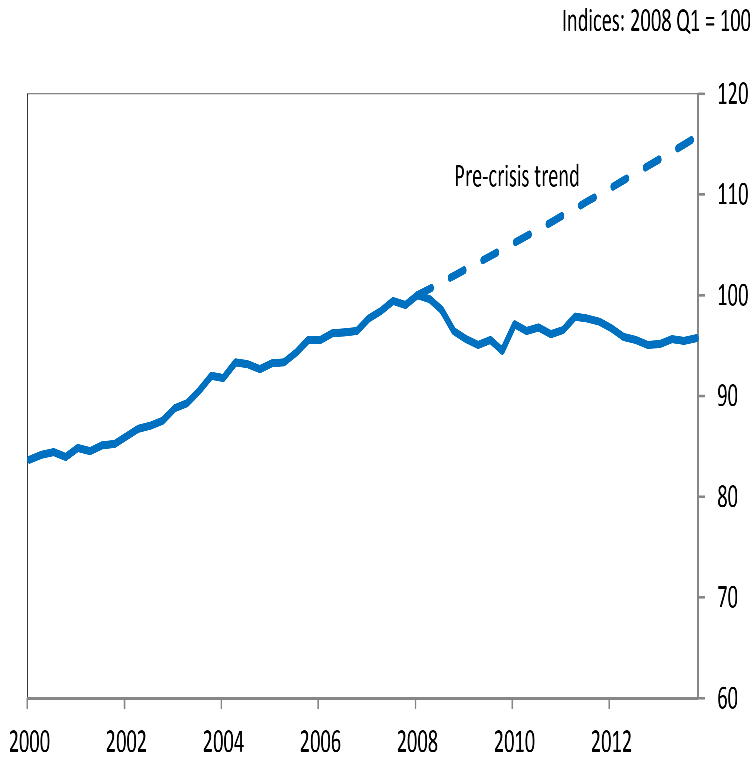
- Can run down APF in three ways:
  - Organic run-off as gilts mature: if start now would take until 2060!
  - Active sales through program of regular auctions once Bank Rate clear of floor; Bank Rate becomes marginal monetary instrument
  - Banks likely to demand more reserves compared to pre-crisis; some gilts may be retained on BoE's balance sheet to back them
- Could APF gilts just be cancelled/replaced by a zero-interest coupon perpetuity?
  - Looks like this benefits Government by reducing debt service costs.
  - But don't forget the BoE pays interest on reserves (that's what Bank Rate *is*!) so BoE will be operating at a loss.
  - What the Government gains by lowering its debt service it loses in terms of lower remittances from the BoE.

Exit timing

- When will policy start to tighten?
  - ➢ Current exceptionally low inflation *not* that material – down to oil, etc, and MPC looks through price-level shocks
  - ➢ Medium-term inflation outlook is the key determinant
  - ➢ Underlying inflation depends primarily on wage growth relative to productivity growth (variations in firm mark-ups only produce transitory movements in inflation)
  - ➢ Productivity *and* wage growth have been unusually weak since crisis; MPC has expected both to pick up for some while now (more below)!
  - ➢ Risks from China may delay tightening, but financial stability risks may bring it forward (to extent FPC cannot mitigate them)
  - ➢ Bank Rate expected to rise only gradually, to a level below historical norms (2-3% v 4-5% pre-crisis)
  - ➢ Reflects a judgement that the “natural” real interest rate will pick up as headwinds from financial crisis abate and demographic influences change sign

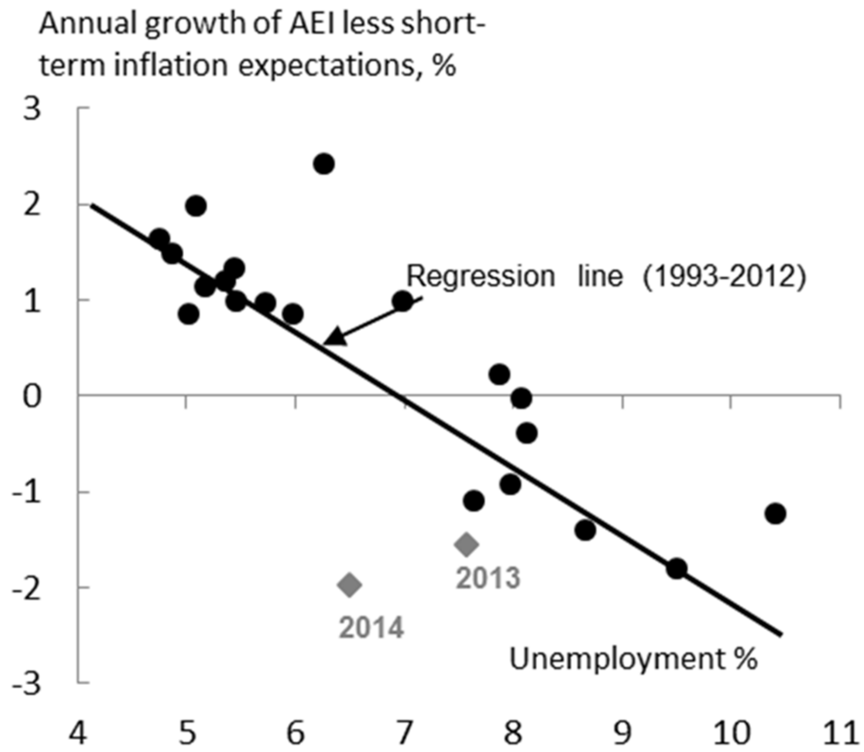
Why has productivity growth been so weak?

- Measurement issues (North-Sea oil; value added in financial services)
- Labour hoarding and overhead labour
- Low investment in capital and R&D
- Employment growth concentrated in low-productivity jobs
- Adoption of more labour-intensive techniques
- Weak wages & high shadow cost of capital
- Heightened uncertainty and irreversible investment
- Shorter production runs
- Thick-market externalities
- Impaired capital allocation after crisis

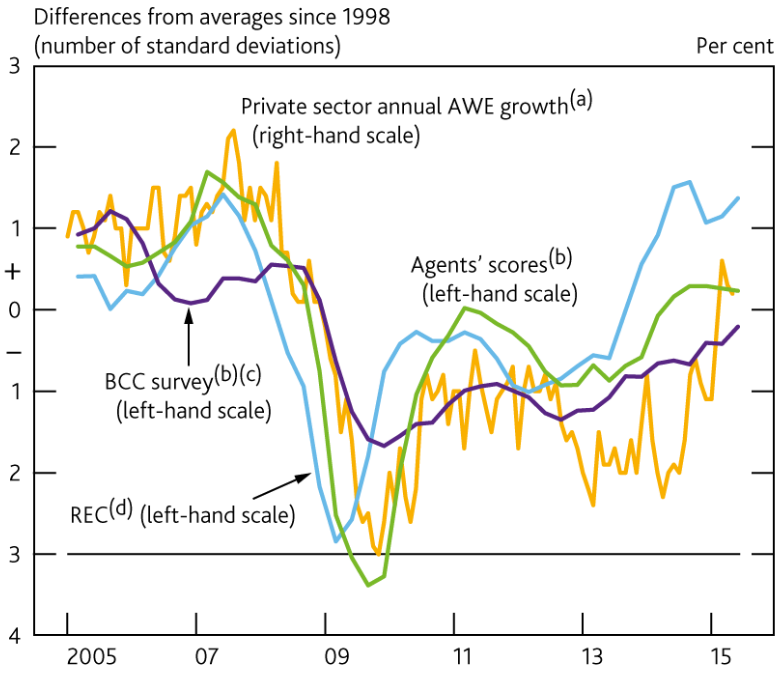


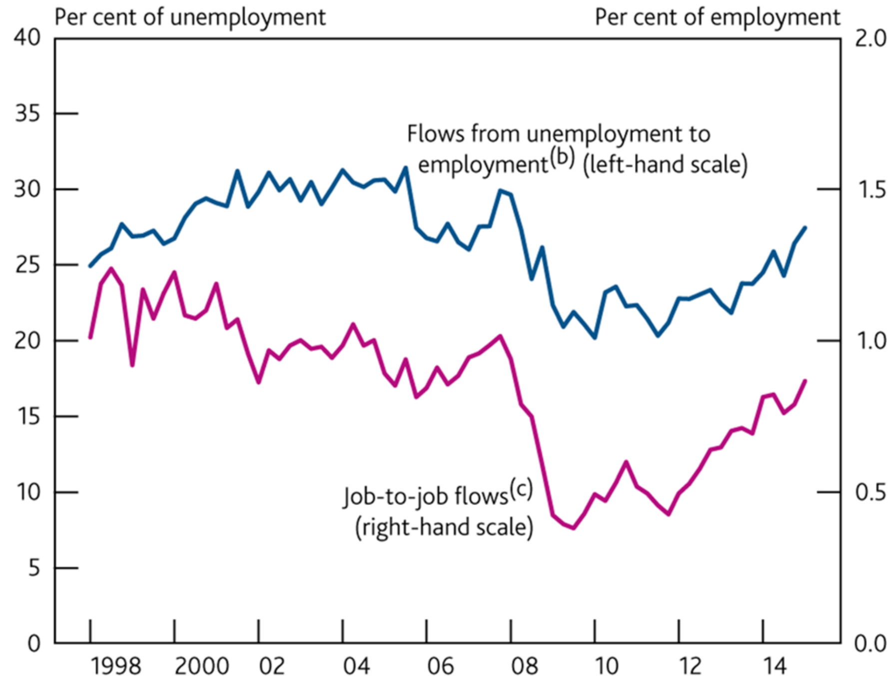
Why has pay growth been so weak?

- Employment growth biased towards the less skilled
- Improved labour market not affecting intra-marginal workers
- Downward shift in wage norms



Earnings indicators and job flows

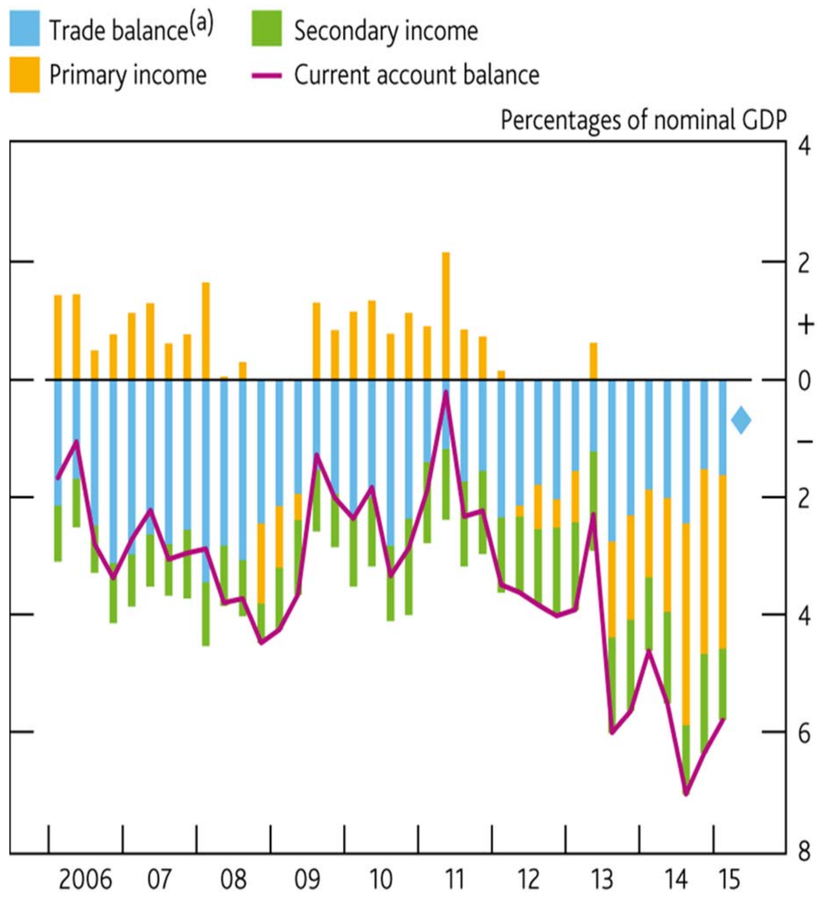




- Recent strengthening in wage growth as job-to-job flows have picked up supports second hypothesis

Imbalances

- Recovery primarily driven by domestic demand (falling saving rate, modest recovery in investment)
- Current account deficit has widened in past three years
- Mainly due to lower earnings on foreign (EU) assets
- Key issue: is this deterioration just temporary?
- Household indebtedness also remains relatively high



Is “Brexit” a material risk?

- Conservatives offered a referendum by 2017 on EU membership to outflank UK Independence Party
  - ➢ Seeking fundamental improvement in UK membership terms
  - ➢ But some demands highly contentious (e.g. restrictions on labour mobility) and/or require Treaty change – most unlikely!
  - ➢ Polls suggest opinion ≈ 50-50; vote to exit is distinct possibility
- Economic consequences (Dhingra, Ottaviano & Sampson, 2015)
  - ➢ Fiscal gain ≈ ½% GDP; Trade integration loss ≈ 1¼%-2½% GDP
  - ➢ But doesn’t take account of longer-run dynamic consequences
  - ➢ May also lead other countries to re-consider their position

Euro Area

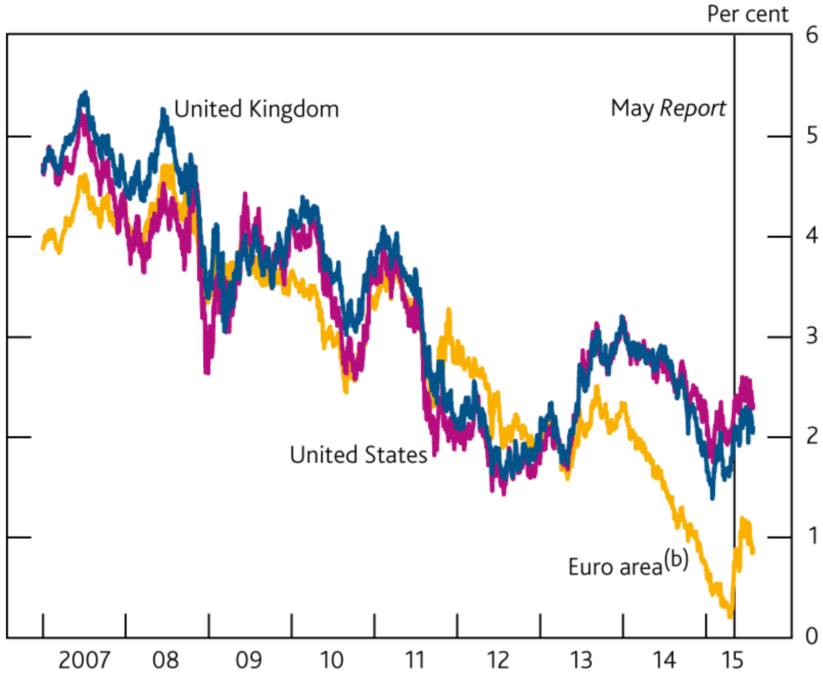
Key challenges for Euro Area

- Preventing low inflation from becoming entrenched
- Dealing with the Greek problem
- Strengthening the institutional architecture

Euro-Area inflation and bond yields

Headline & core inflation

10-year bond yields

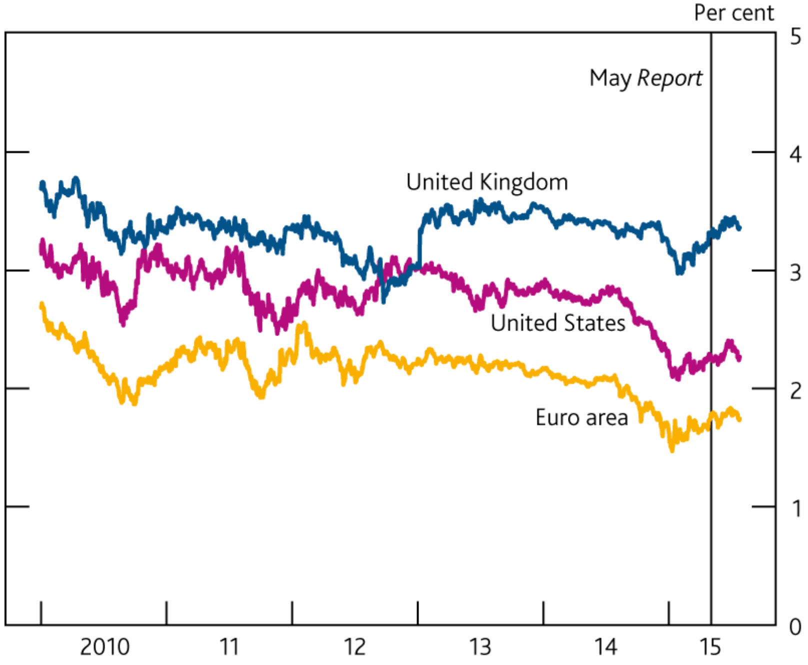


Source: European Central Bank and Bank of England

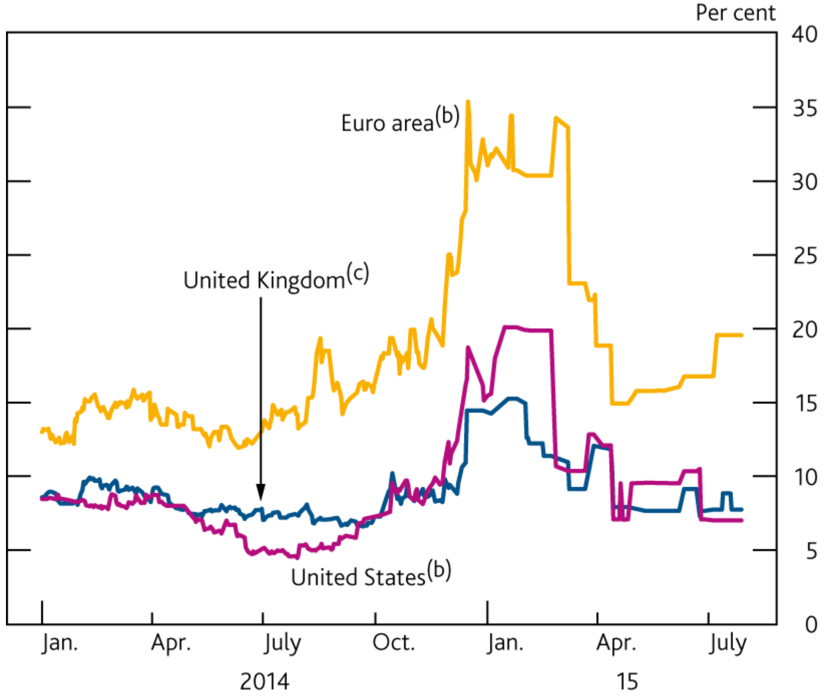
- Underlying inflation consistently below target since crisis
- Euro-area yields ≈ 1pp below US & UK yields since 2012

Inflation expectations in the Euro Area

5-year 5-years forward implied inflation



Option-based probability of deflation 3 years ahead



Source: Bank of England

Euro Area monetary policy

- ECB active in providing liquidity to banks during crisis but slower to adopt asset purchases (QE) than Fed, BoE.
- Event studies suggest QE1 in US, UK reduced bond yields by ≈1pp, though impact of QE2 weaker; probably also helped to anchor inflation expectations.
- ECB (German) reluctance to adopt QE raised expectations of deflation (Art.123 of TFEU fundamentally misconceived).
- Euro Area also slow to recapitalise banks (partly institutional deficiencies, partly faulty diagnosis).
- Echoes of Japan's "two lost decades", but start of PSPP in March contributed to fall in expectations of deflation.
- Policy now firmly expansionary though slow reaction may have made task harder than it needed to be.

Greece

- Unlike other periphery EU states where fiscal weakness reflected financial crisis, Greek fiscal position was already weak.
- Aim to rebalance economy through fiscal consolidation plus “internal devaluation”: 19.4% gain in competitiveness since 2009 (Ireland 18.1%; Portugal 9.5%; Spain 14.0%).
- But demand for Greek exports quite insensitive to relative prices, while fiscal consolidation plus lower real wages has depressed domestic demand (GDP down 25%).
- Also fundamental structural problems: weak tax collection; monopolistic industries; overly generous pensions.
- Further debt relief/restructuring inevitable, but issue of sequencing: creditors (esp. Germany) only prepared to concede relief after progress made on structural reforms.

Two visions of Europe

Germany

- Rules
- Liability
- Solvency
- Austerity/reform

France

- Discretion
- Solidarity
- Liquidity/contagion
- Keynesian stimulus

- Fundamental problem for EU
  - ➢Euro area needs more integration (complete banking union; more fiscal integration)
  - ➢Some “out” countries (especially UK) want free trade but not full economic/political integration
  - ➢Need to work out the architecture of a Europe of “concentric circles”