

Europe's Changing Position in the World Economy

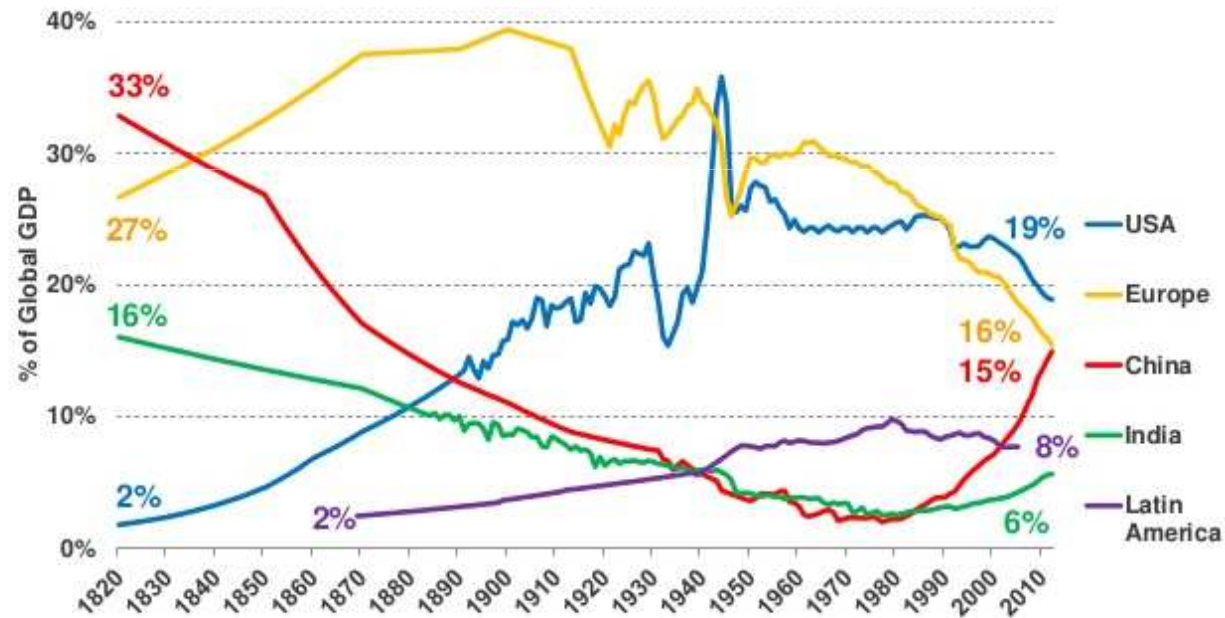
Barry Eichengreen

November 1, 2013

Here it is

GDP =
China Share Gains vs. Europe & USA are Epic

Percent of Global GDP, 1820 – 2012,
USA vs. Europe vs. China vs. India vs. Latin America



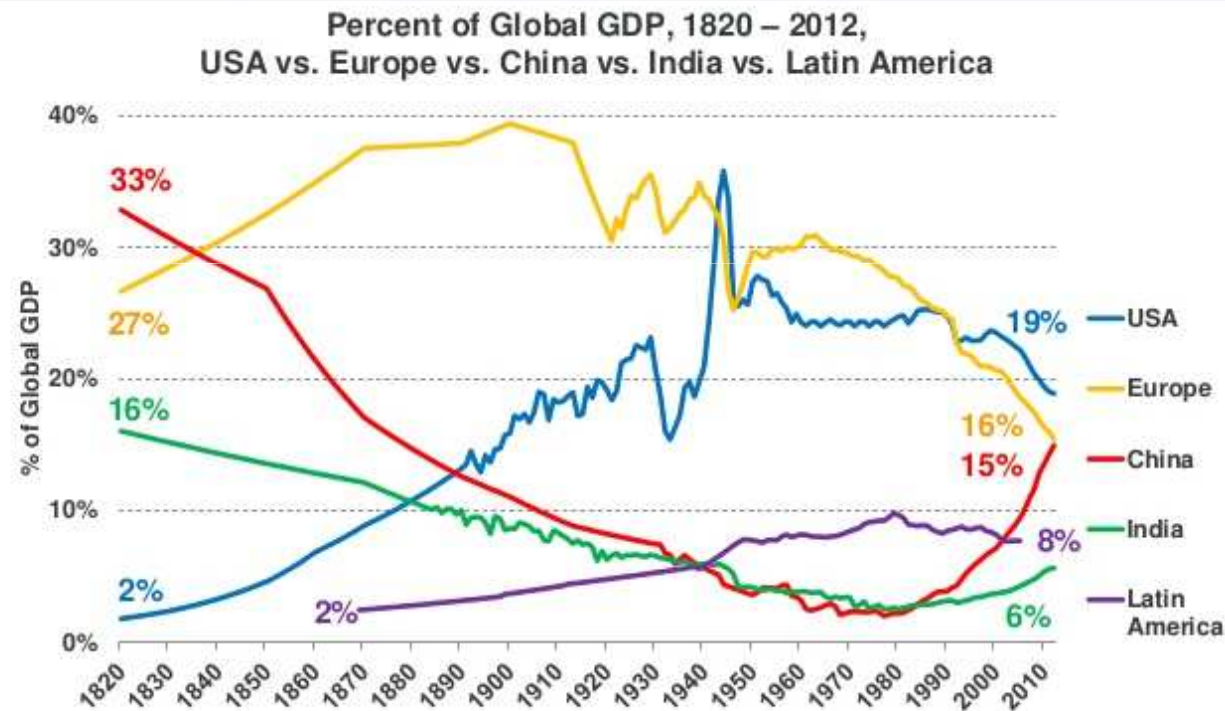
KPCB

Source: Angus Maddison, University of Groningen, OECD, data post 1980 based on IMF data (GDP adjusted for purchasing power parity).

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One doesn't have to be a sophisticated geopolitical strategist...

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China Share Gains vs. Europe & USA are Epic



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So what are Europe's prospects?

- I would like to provide four perspectives.

Perspective 1:

Growth as the enemy of reform

- Europe has slipped into a bad equilibrium where the EC and ECB see growth removing the pressure to reform.
- There is indeed some evidence that each time market pressure dies down (after OMT) and growth accelerates, reformist zeal is lost.
- This leaves the central bank hesitant to do more to support economic growth. It hesitates to buy bonds of troubled governments for fear that efforts at fiscal consolidation and structural reform will slow.
- It leaves the Commission reluctant to recommend less austerity for the same reason.
- Thus, too much growth is seen as a bad thing.

And the solution?

- It is not the role of the central bank to manage structural reform or fiscal policy.
 - It should keep its eye on its de facto triple mandate: price stability, full employment, and financial stability (that's a full plate).
- The Commission should actively link fiscal space/fiscal stimulus to structural reform.
 - This puts me in the unfashionable position of actually supporting Mr. Dijsselbloem's proposal to this effect in a speech earlier this week.

Perspective 2:

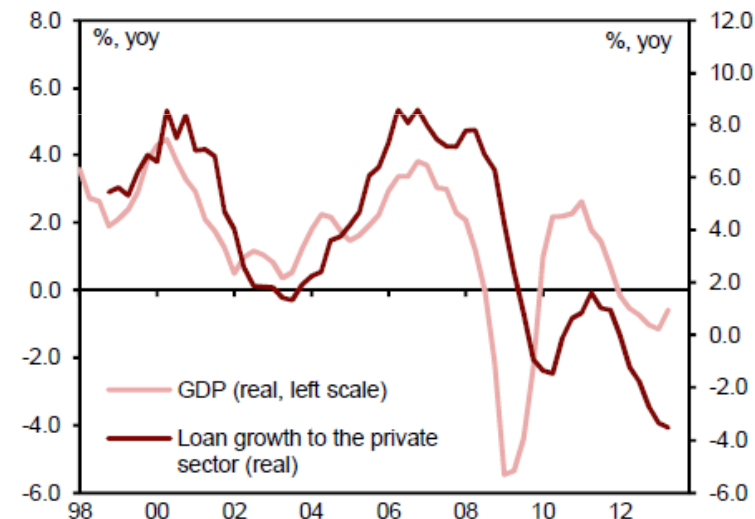
Avoiding a Japan-style lost decade

- Europe is already halfway there.
- Ingredients of Japan's lost decade are well known:
 - Failure to resolve banking crisis.
 - Failure to avoid deflation.
- Are these a risk in Europe?
 - Clearly yes.

And the solution?

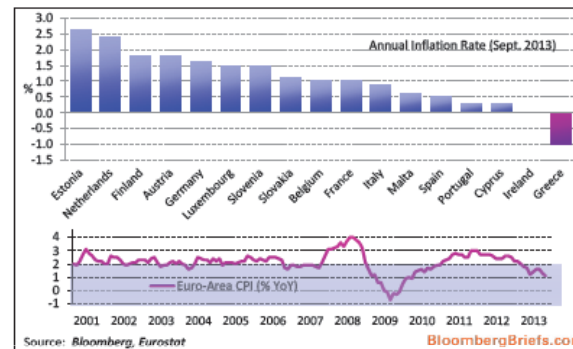
- First, swift, forceful bank recapitalization
 - Asset quality reviews and stress tests are supposed to be part of this process.
 - But three previous stress tests were also supposed to be part of this process.
 - Basics like including sovereign bonds in stress tests are still in dispute.
 - Can the ECB and EBA do a meaningful stress test that reveals serious capital shortfalls without having a mechanism for direct bank recap in place?

Exhibit 6: Euro area GDP has stabilised while lending growth continues to decline



Plus a monetary policy that avoids deflation (good luck with that...)

Inflation May Turn to Deflation



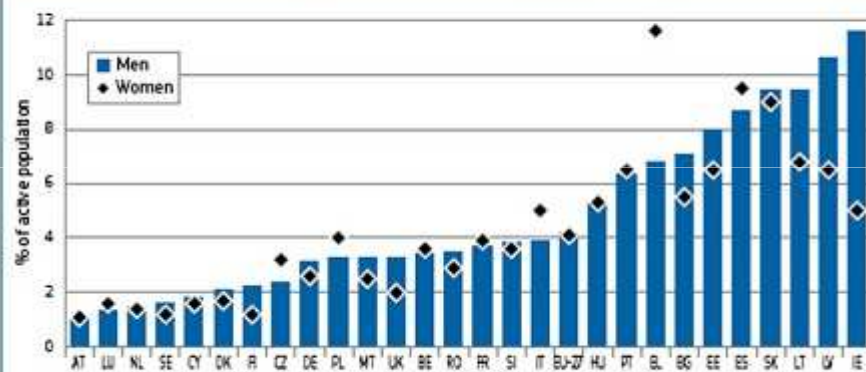
The pace of inflation has almost halved since the start of the year to a three-and-a-half year low of 1.1 percent in September. Core prices are near a record low of 0.8 percent at 1 percent. Greece is already experiencing deflation as prices fell at an annual rate of 1 percent in September. Spain's 0.5 percent CPI rate may already be negative once the increase in the 3 percentage point rise in VAT is excluded.

Deflation Risks Increase as Euro Strengthens



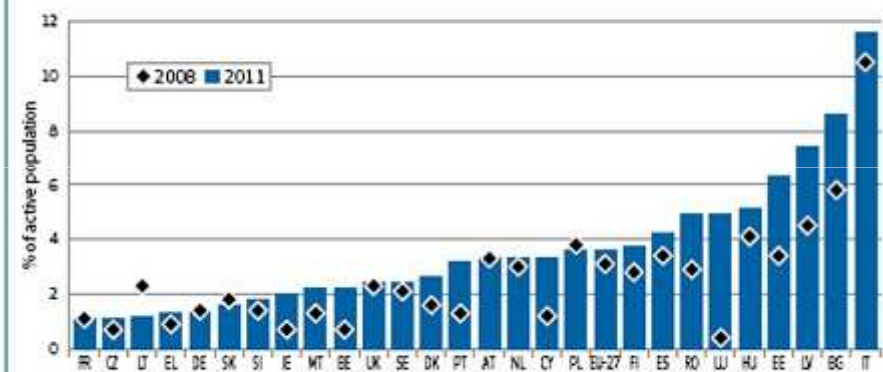
Perspective 3: Long term unemployment causes long term damage

Chart 22: Long-term unemployment rate (for men and women) as a percentage of the active population, 2011



Source: DG EMPL calculations based on Eurostat, EU-LFS.

Chart 15: Persons available and wanting to work but not seeking a job, as a percentage of the active population



Source: Eurostat, EU-LFS.

This has been amply documented

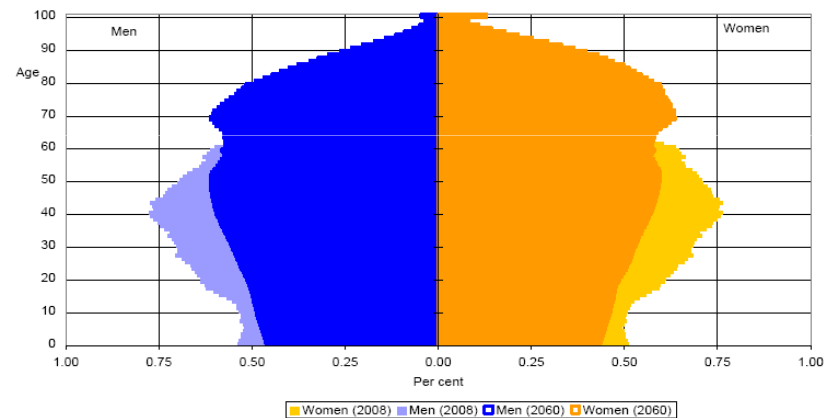
- In the US, workers who lost jobs in the mass layoffs of the early 1980s were making 20 per cent less than their peers two decades later.
 - Von Wachter, Song and Manchester, “Long-Term Losses Due to Mass Layoffs During the 1982 Recession,” Columbia University (2009).
- Long-term unemployed suffer a variety of (mental and physical) illnesses that damage productivity.
 - Morin and Kochhar, “Lost Income, Lost Friends, and Loss of Self-Respect,” New York: Pew Foundation (2010).
- Literacy and numeracy skills are even damaged by long term unemployment.
 - Edin and Gustavvson, “Time Out of Work and Skill Depreciation,” *ILRReview* (2008).
- Similar effects are amply documented in the literature on the Great Depression.
 - Eichengreen and Hatton, “Interwar Unemployment in International Perspective” (1987).

And the solution?

- Training programs and all that (with which Europe has lots and lots of experience).
- And, of course, economic growth.

Perspective 4: Demography

- Demography may not be destiny, but it has a lot to do with it.
- Firm-level evidence is pretty strong that technology absorption depends positively on share of population aged 15-29, and that overall productivity growth falls with share of employees 50-65 (don't take this personally).
 - Fent, Mahlberg and Prskawetz, “Demographic Change and Economic Growth” in Kohlbacher and Herstatt (eds), *The Silver Market Phenomenon* (2009).



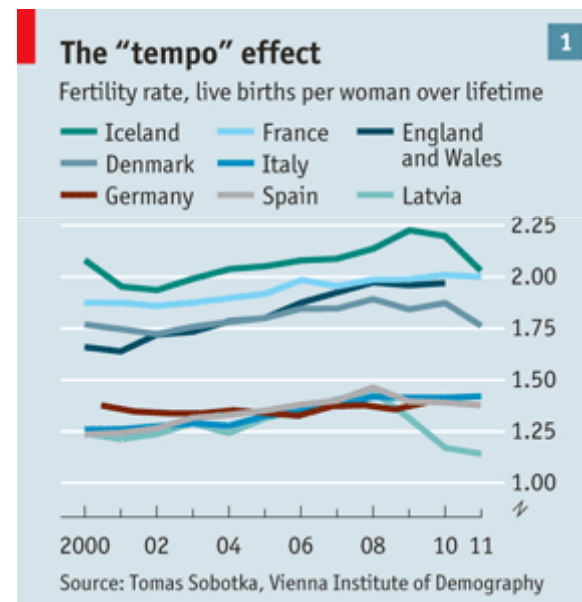
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- More generally, more immigration friendly policies.
 - If the president of the European Parliament is now advocating this, maybe there is hope...
- And a more growth friendly regime in the short run (bringing me full circle).
 - Since we know that family formation and fertility rates are responsive to economic conditions.
 - We know this courtesy of work on the Great Depression (Kiser and Whelpton's "Indianapolis Study").
 - Things like home care child allowances (Finland in the 1990s) can moderate the impact.



- Thank you.