



Challenges of the EA compared with the US and Japan

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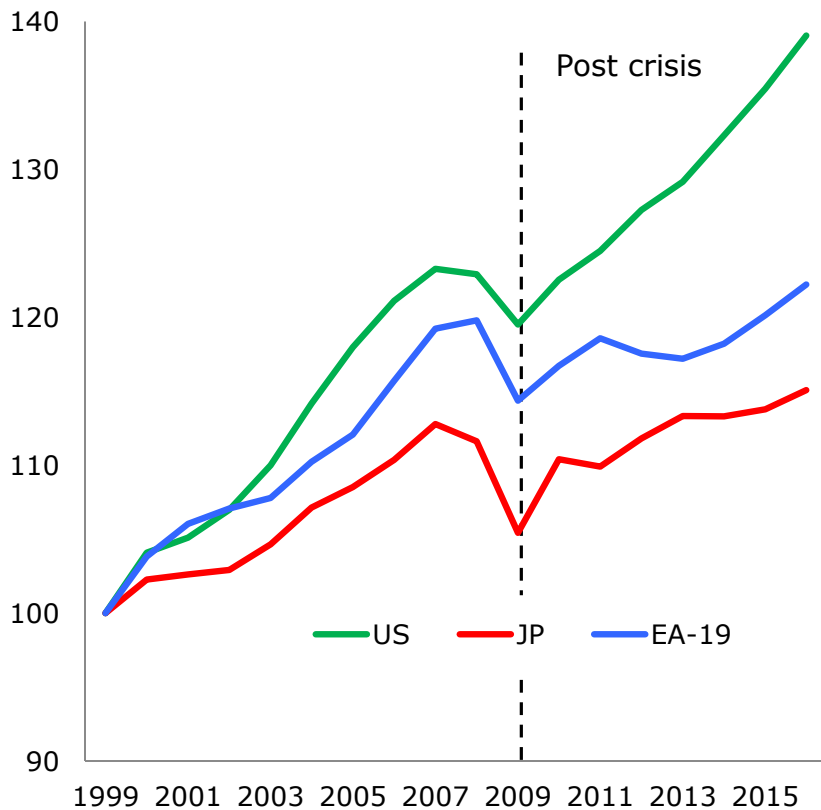
**Belgian Financial Forum
Brussels, 21 March 2016**

Outline

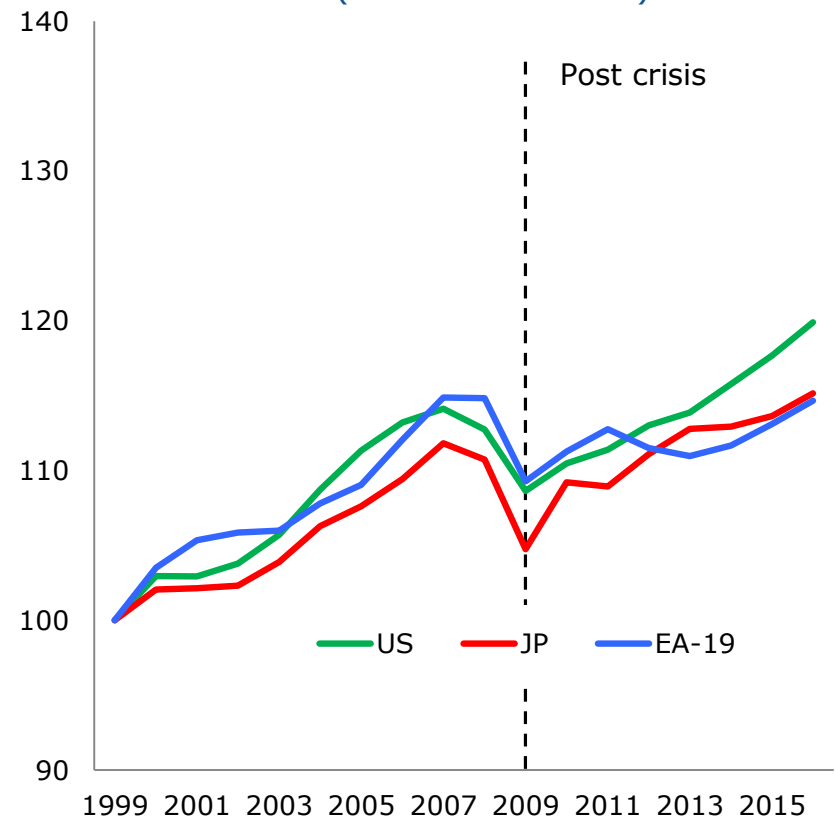
- 1. Significant growth differences between EA, US and Japan**
- 2. Where do the differences between EA and US come from?**
- 3. Will the euro area become the "next Japan"?**

Substantial growth differences between EA, US and JP, partly explained by demographics

Real GDP
(Index: 1999=100)



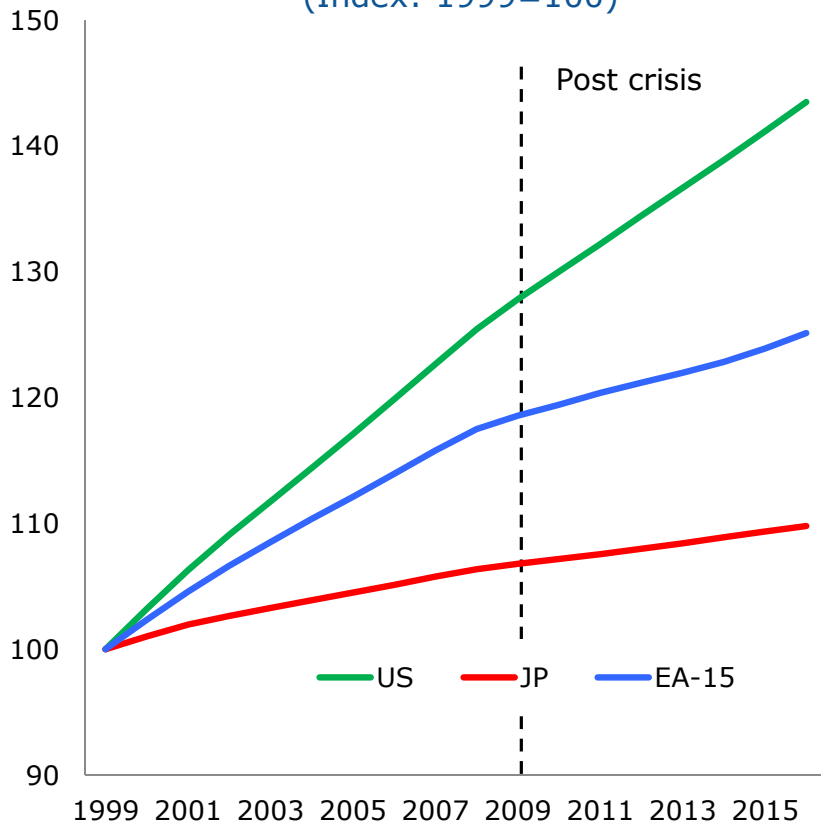
Real GDP per capita
(Index: 1999=100)



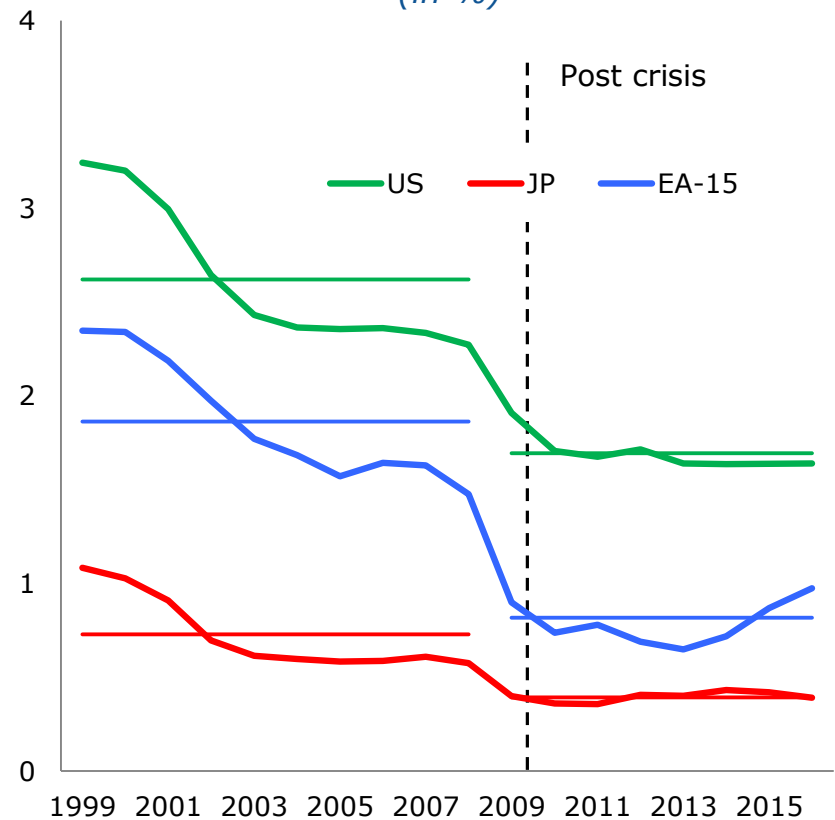
Source: Own calculations based on Ameco data.

Significant differences in potential GDP growth

Potential GDP level
(Index: 1999=100)



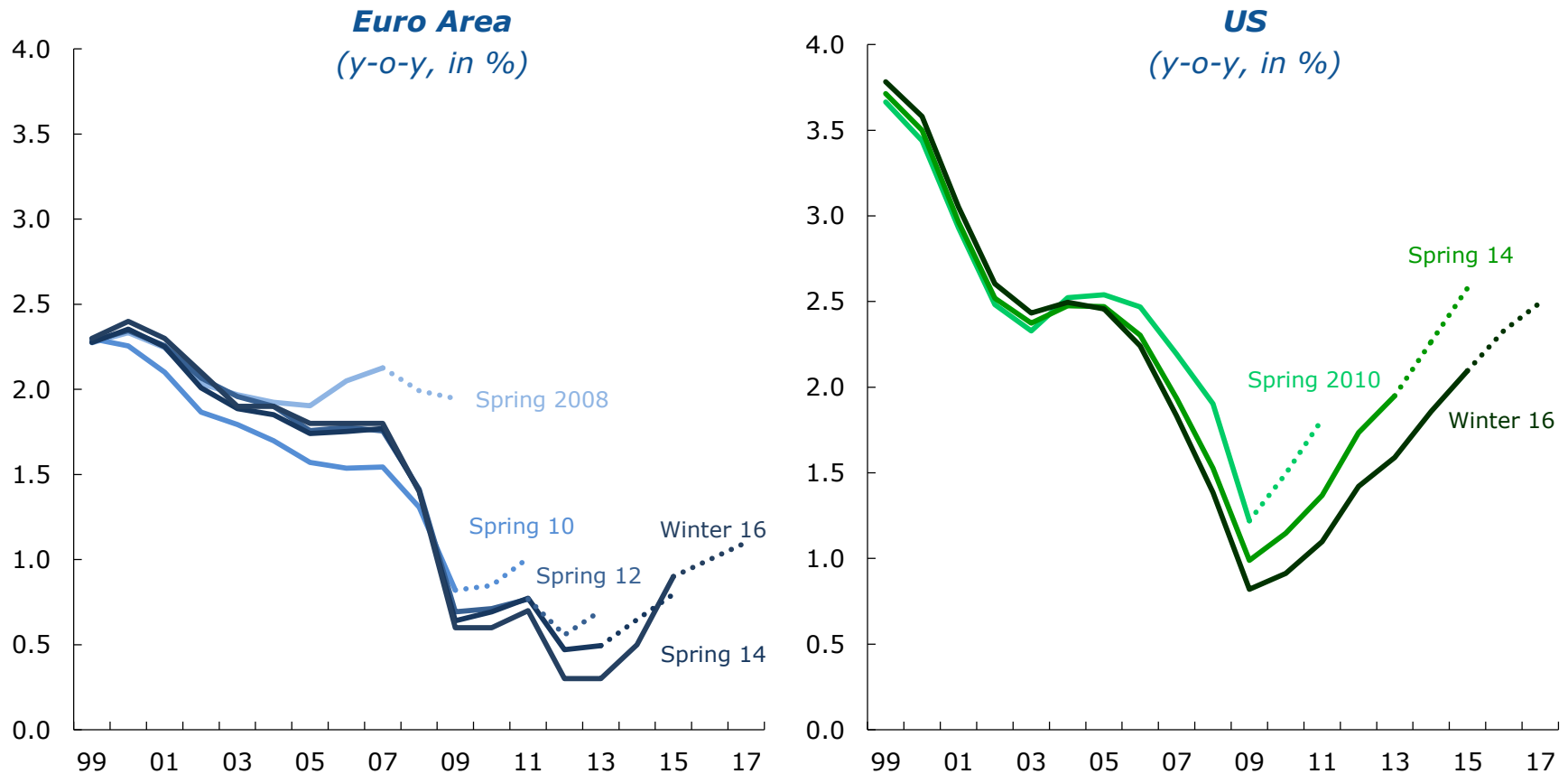
Potential GDP growth
(in %)



Source: Own calculations based on OECD data.

Repeated downward revisions of potential growth

Comparison of potential growth projections over past forecast vintages



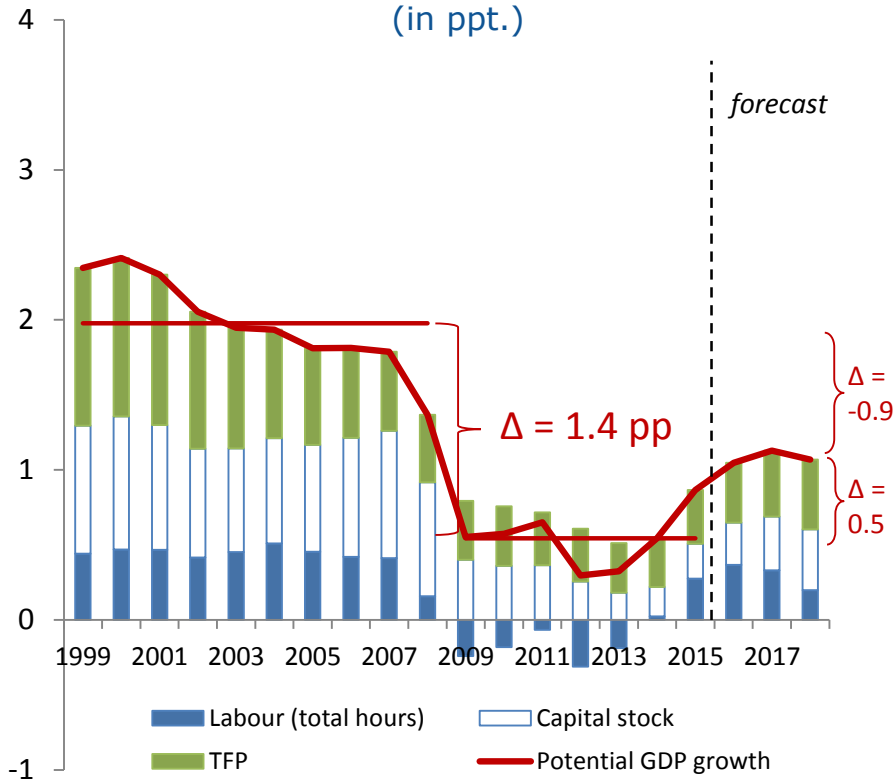
Note: Euro area based on EA-15 (spring 2008), EA-16 (spring 2010), EA-17 (spring 2012), EA-18 (spring 2014), EA-19 (winter 2016). For the US, forecast vintages for 2008 and 2012 are not available.

Source: Own calculations based on Ameco.

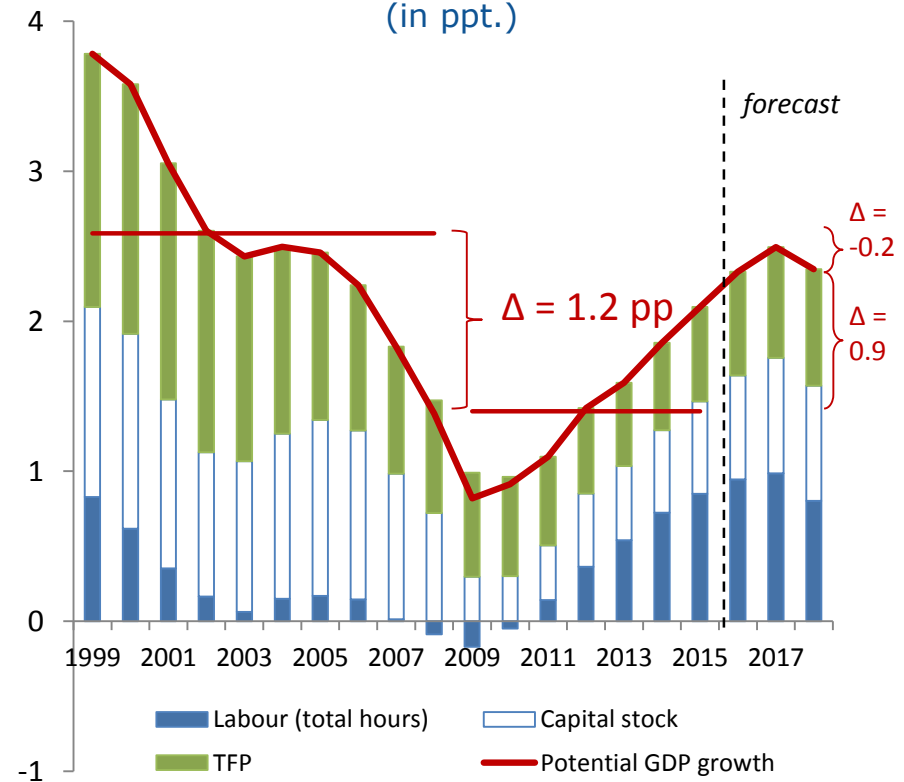
Differences in potential growth between EA and US exacerbated by financial/sovereign debt crisis

Contributions to potential growth

Euro area
(in ppt.)



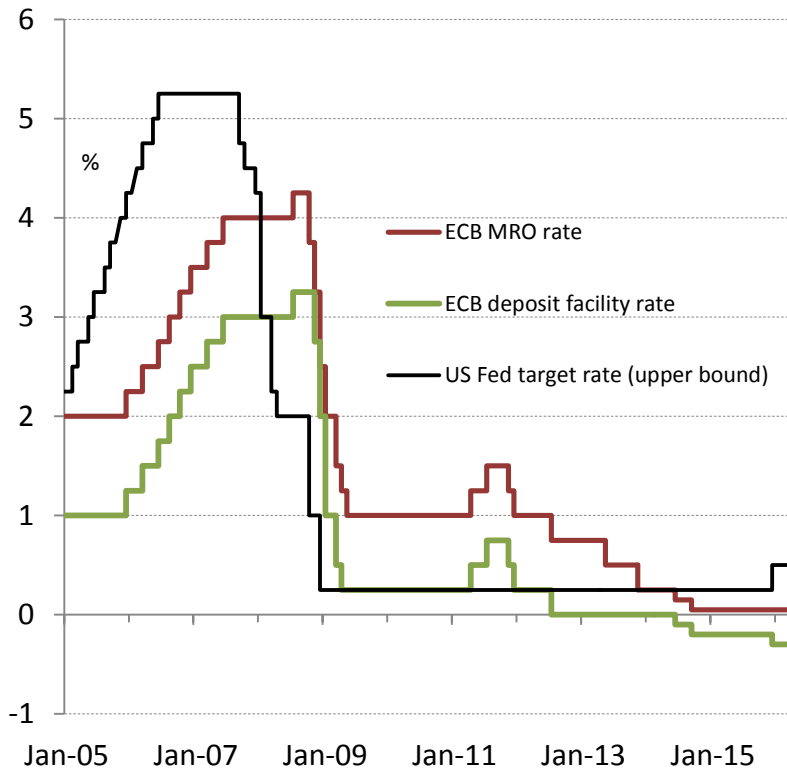
US
(in ppt.)



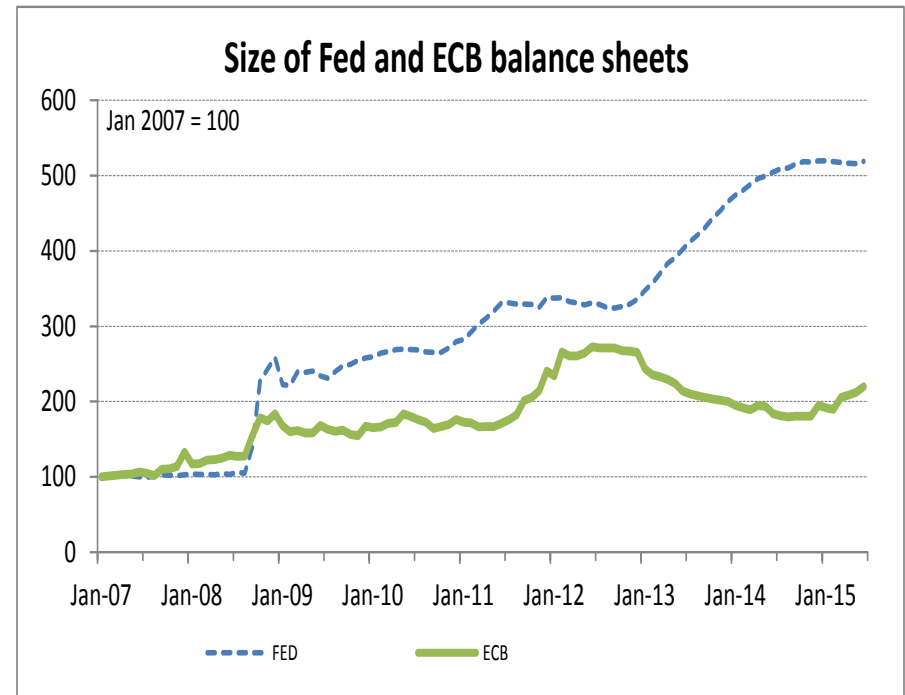
Source: DG-ECFIN calculations, Winter Forecast 2016.

Monetary policy response: more front-loaded action by Fed than ECB

Policy rates set by the ECB and the US



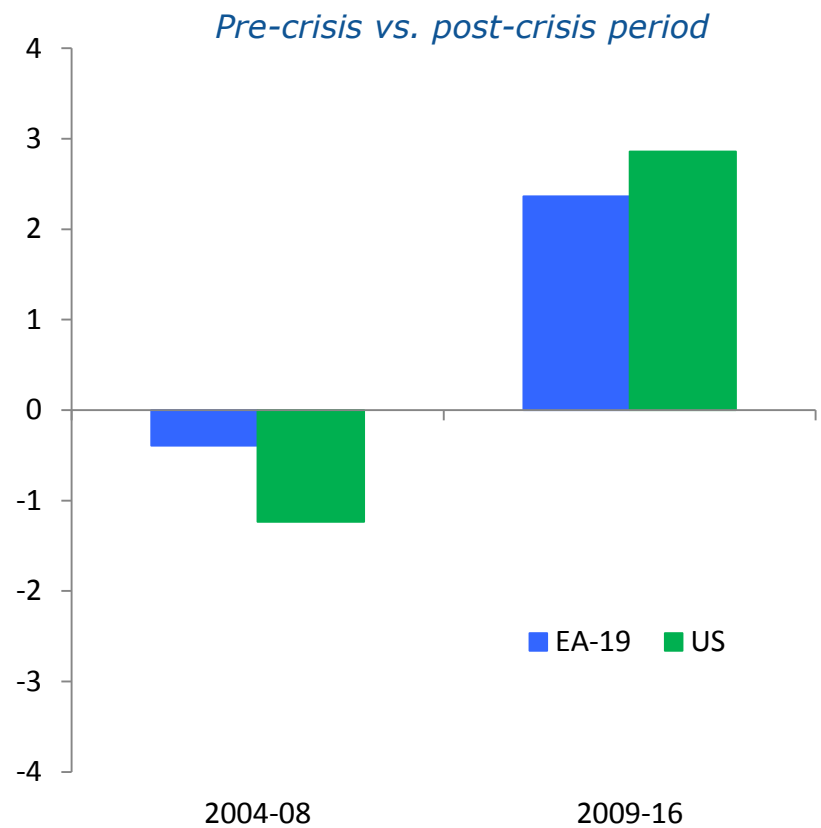
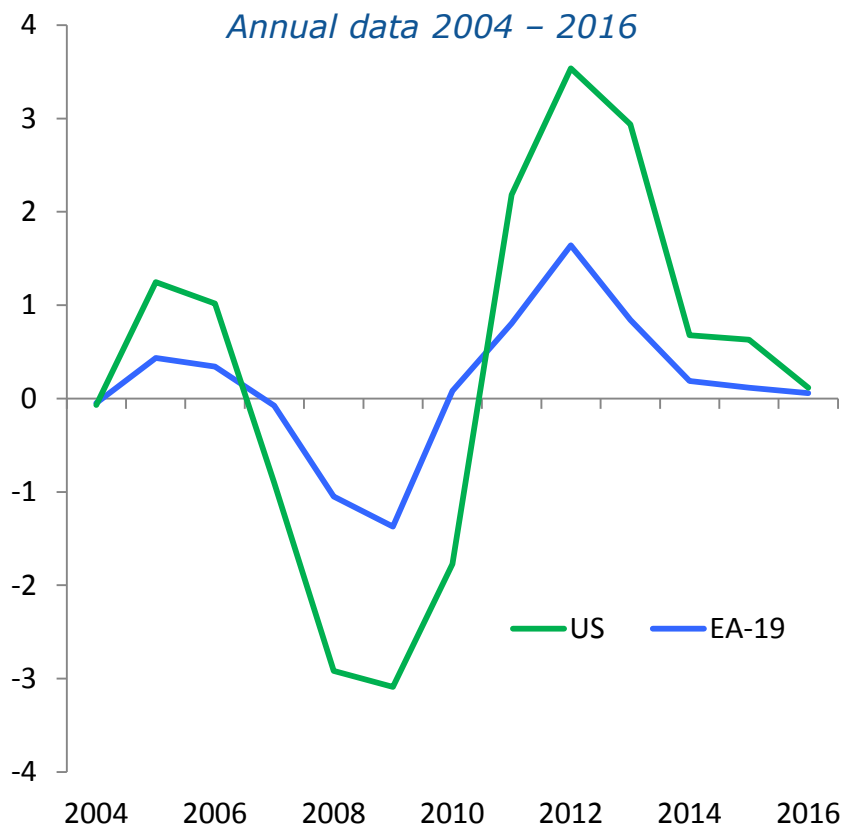
**ECB and Fed balance sheets
(% of GDP)**



Source: HIS. Last observation 15 march 2016.

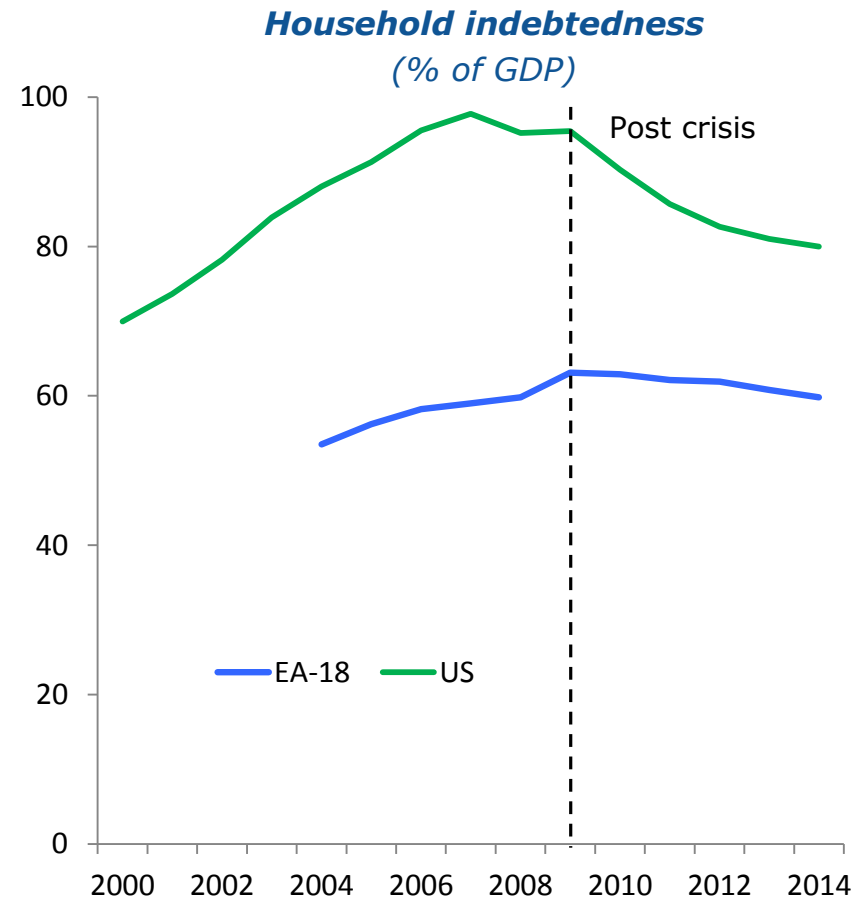
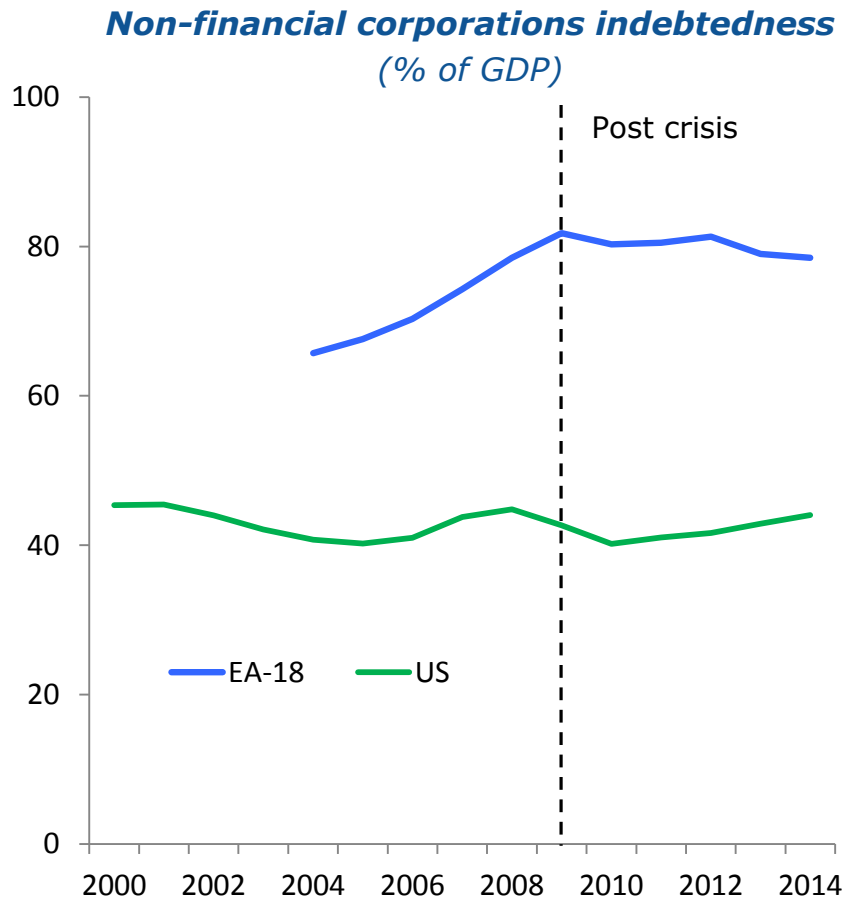
Fiscal policy response: broadly similar timing but stronger cycles in the US

Change in structural balances (in % of GDP)



Source: Own calculations based on IMF World Economic Outlook, October 2015.

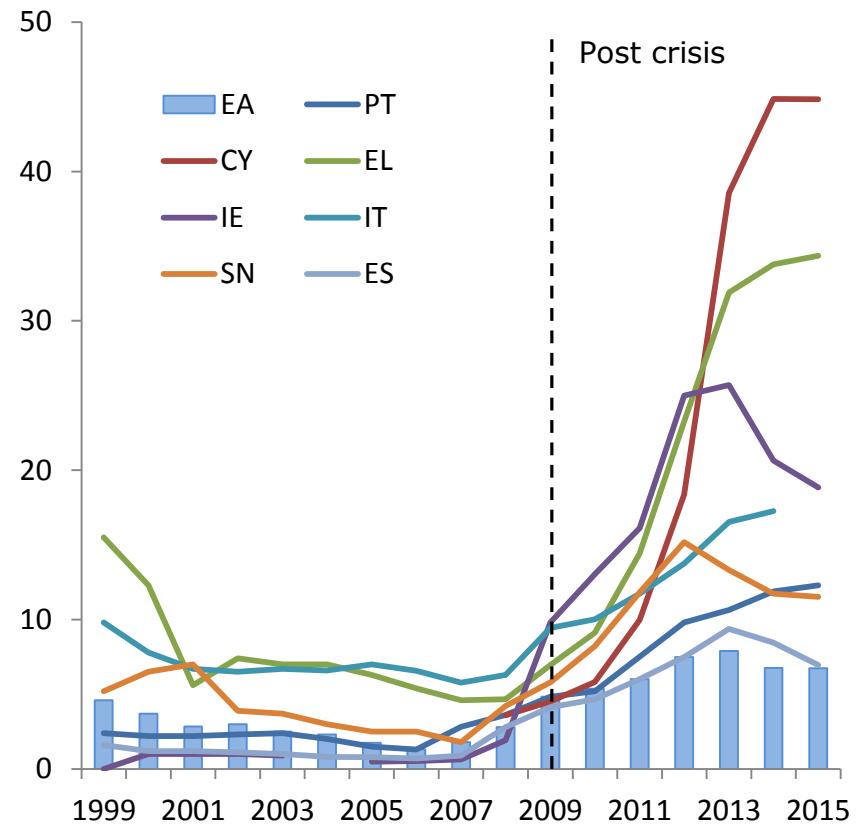
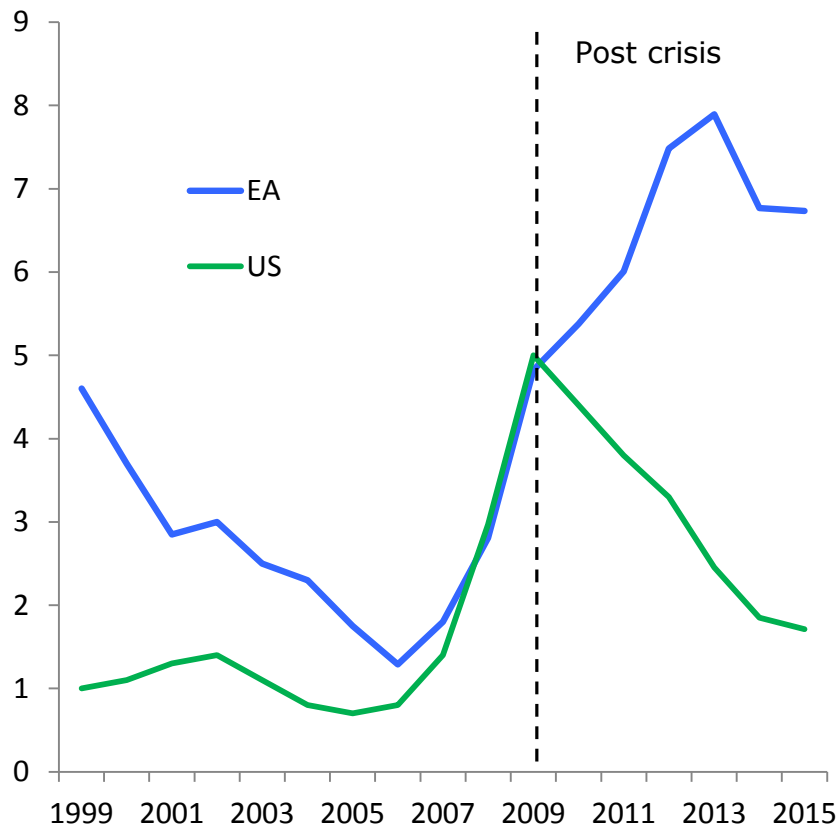
Private sector deleveraging: higher needs and less progress in EA than in US



Note: Data consolidated at sector level shown in descending order for values observed in 2014. The initial observation is 2000 except (due to data availability): 2001 for DE and NL, 2002 for IT and 2004 for AT and FI. Source: EA data from Eurostat, US data from Bureau of Economic Analysis.

High NPLs remain a major concern for the Euro Area, in particular for the vulnerable Member States

Bank non-performing loans to gross loans
(in %)



Source: World Bank World Development Indicators.

Flaws in EA governance framework

Fiscal	<i>Stronger preventive arm SGP</i>	<ul style="list-style-type: none"> • Introduction of an expenditure rule (<i>6-P</i>) and balanced budget rule (<i>TSCG</i>) • Possibility of imposing sanctions (<i>6-P</i>) • Surveillance of draft budgetary plans by Commission (<i>2-P</i>)
	<i>Stronger corrective arm SGP</i>	<ul style="list-style-type: none"> • Introduction of a numerical debt benchmark (<i>6-P</i>) • Earlier and more gradual sanctions (<i>6-P</i>) • More automaticity in decision-making via new voting scheme (<i>TSCG</i>) • Enhanced surveillance for MS threatened with financial difficulties (<i>2-P</i>)
	<i>National fiscal frameworks</i>	<ul style="list-style-type: none"> • Mandatory minimum requirements at the national level (accounting and statistics, forecasts, fiscal rules monitored by independent bodies, transparency)
Macro		<ul style="list-style-type: none"> • Prevention and correction of macroeconomic imbalances via the introduction of the Macroeconomic Imbalance Procedure (<i>MIP</i>) (<i>6-P</i>)
Crisis resolution mechanism		<ul style="list-style-type: none"> • European Stability Mechanism (<i>ESM</i>) • OMT programme by the European Central Bank (<i>ECB</i>)
Financial	<i>Eur. System of Financial Supervision</i>	<ul style="list-style-type: none"> • Macro-prudential: European Systemic Risk Board (<i>ESRB</i>) • Micro-prudential: European Supervisory Authorities (<i>ESAs</i>) with <i>EBA</i> (for banks), <i>ESMA</i> (securities), <i>EIOPA</i> (insurance), national authorities etc.
	<i>Banking Union</i>	<ul style="list-style-type: none"> • Single Supervisory Mechanism (<i>SSM</i>) • Single Resolution Board (<i>SRB</i>) and Single Resolution Fund (<i>SRF</i>) • Under construction: Common deposit insurance scheme

Note: Key reforms steps taken in the area of fiscal and macroeconomic policies are shown in italics in brackets, namely 6-Pack (6-P), Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), 2-Pack (2-P).

Major differences in the decline of potential GDP between EA and the US stem from weak labour and TFP contribution

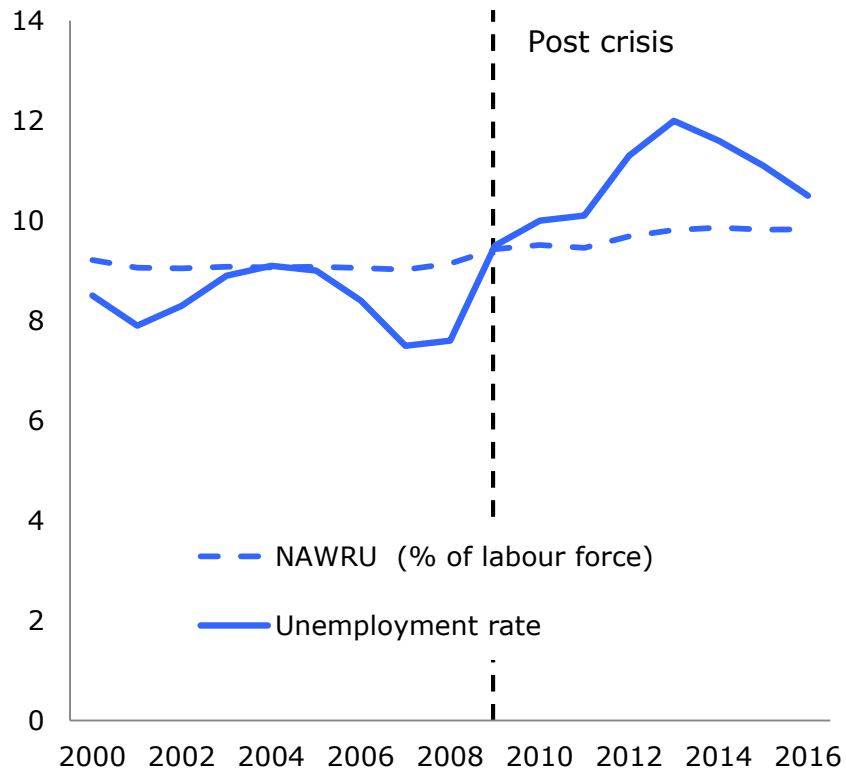
Contributions to potential growth

		Potential growth (annual % change)	Contributions to potential growth (in pps.)		
			<i>Labour (persons)</i>	Capital accumulation	TFP
EA-19	1999-08	2.0	0.4	0.8	0.8
	2009-15	0.5	-0.1	0.3	0.4
	Diff.	-1.4	-0.5	-0.5	-0.4
US	1999-08	2.6	0.2	1.1	1.3
	2009-15	1.4	0.3	0.4	0.6
	Diff.	-1.2	0.1	-0.6	-0.7

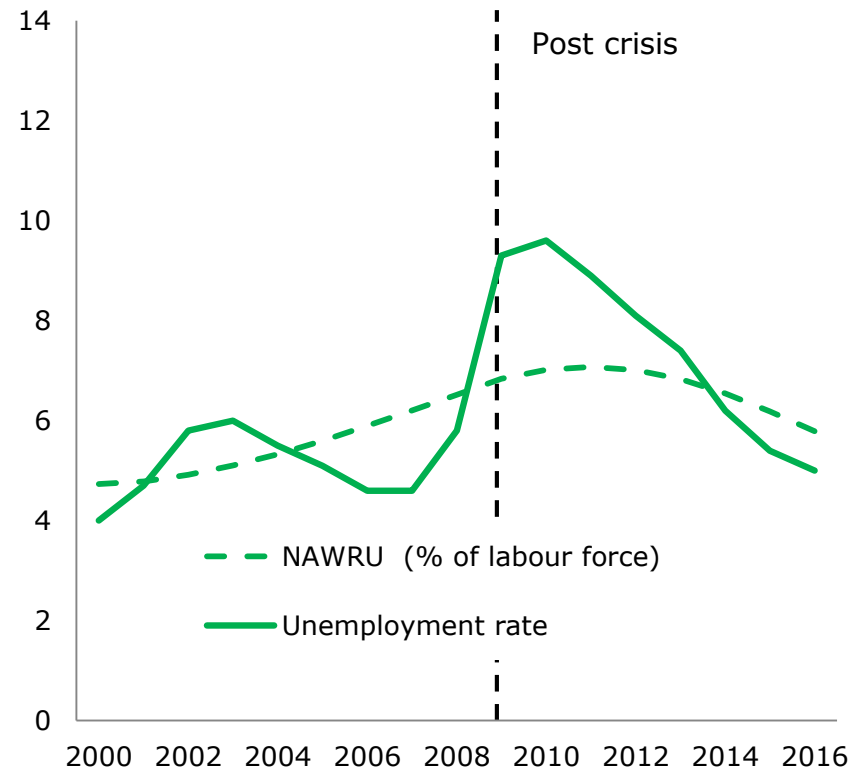
Source: DG-ECFIN calculations, Winter Forecast 2016.

Faster labour market adjustment in the US compared with the EA

Euro area



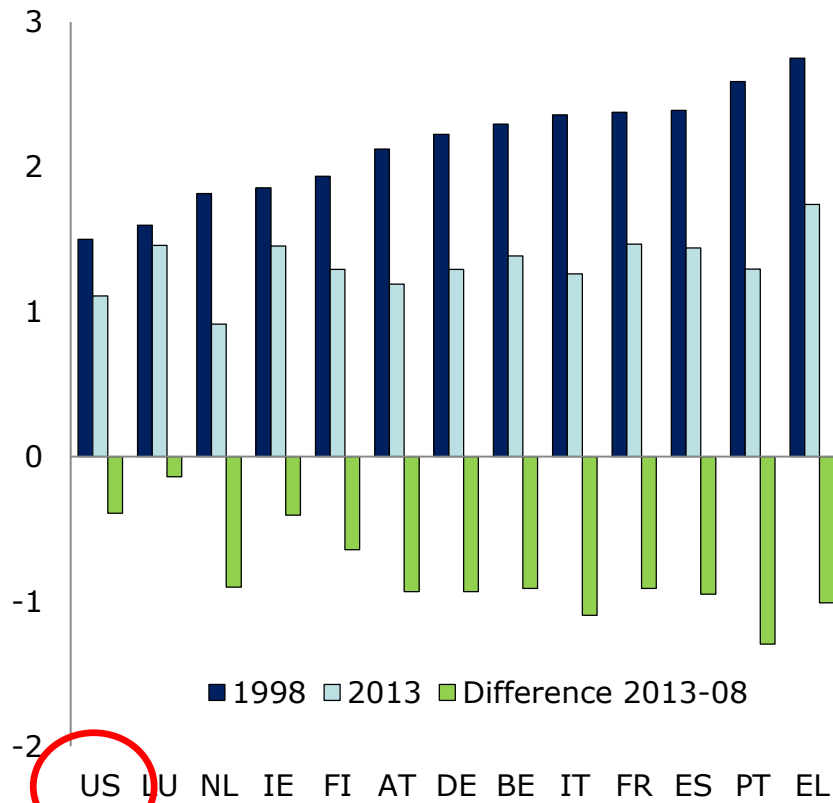
US



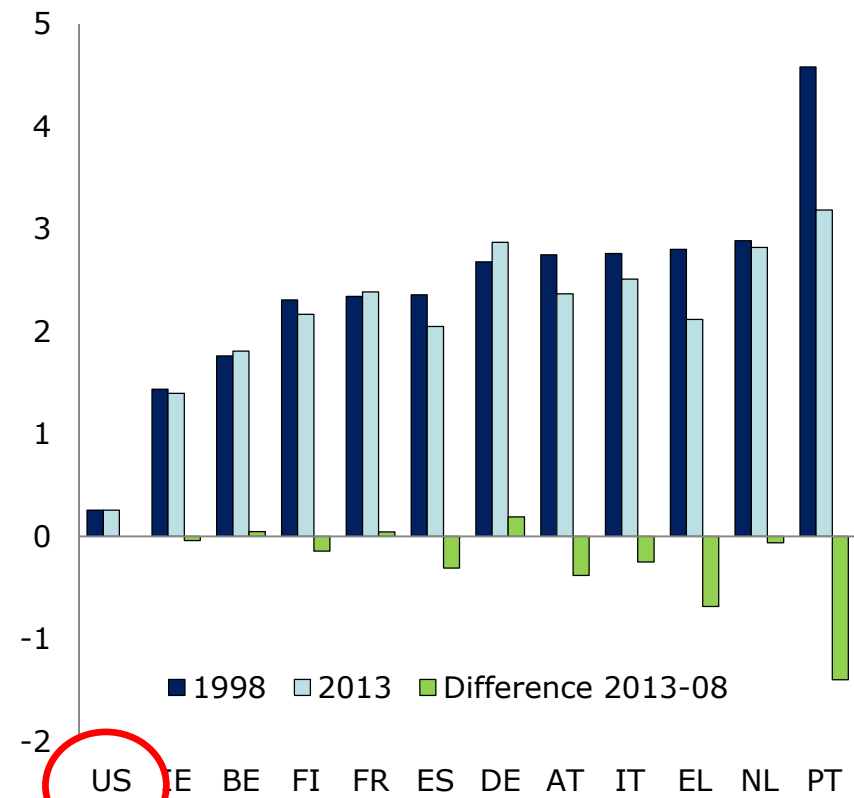
Source: DG-ECFIN calculations, Winter Forecast 2016.

More flexible labour and product markets in the US facilitated adjustment after the crisis

Product market regulation



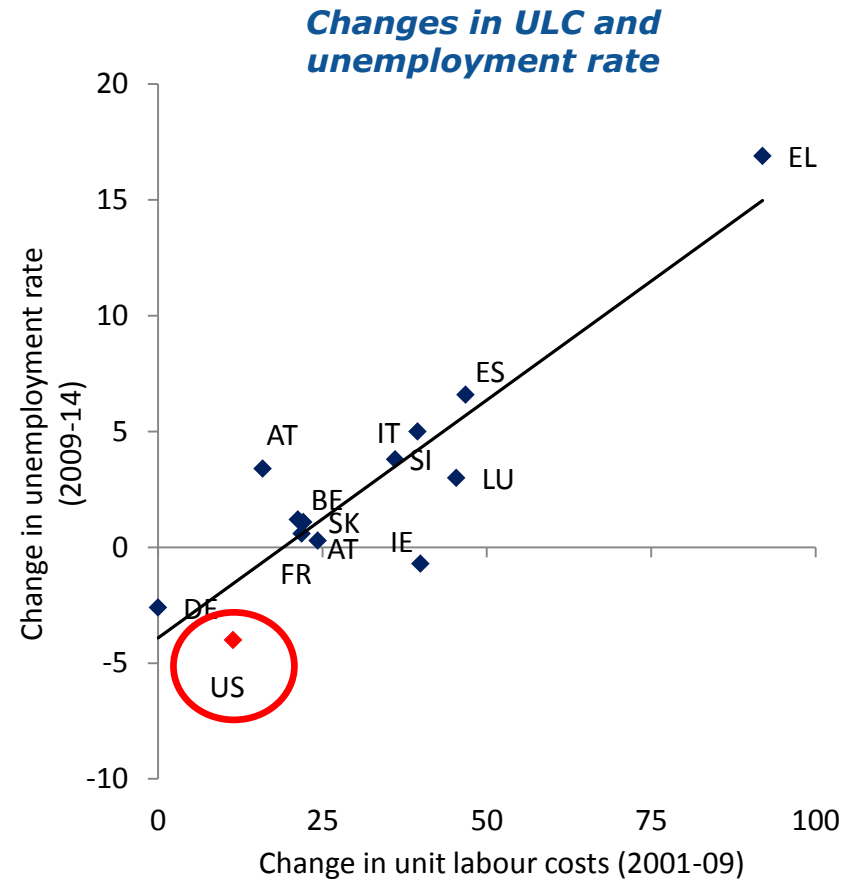
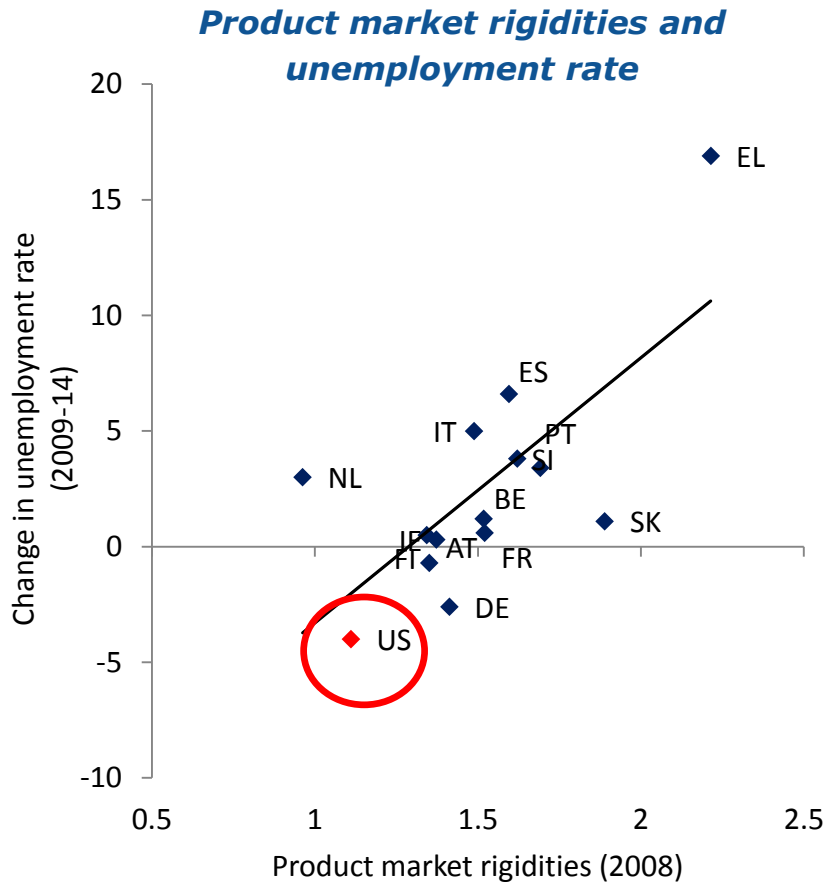
Employment protection legislation



Note: Indicators range on a scale from 0 (least restrictions) to 6 (most restrictions). EPL refers to individual and collective dismissals. Latest data available 2013.

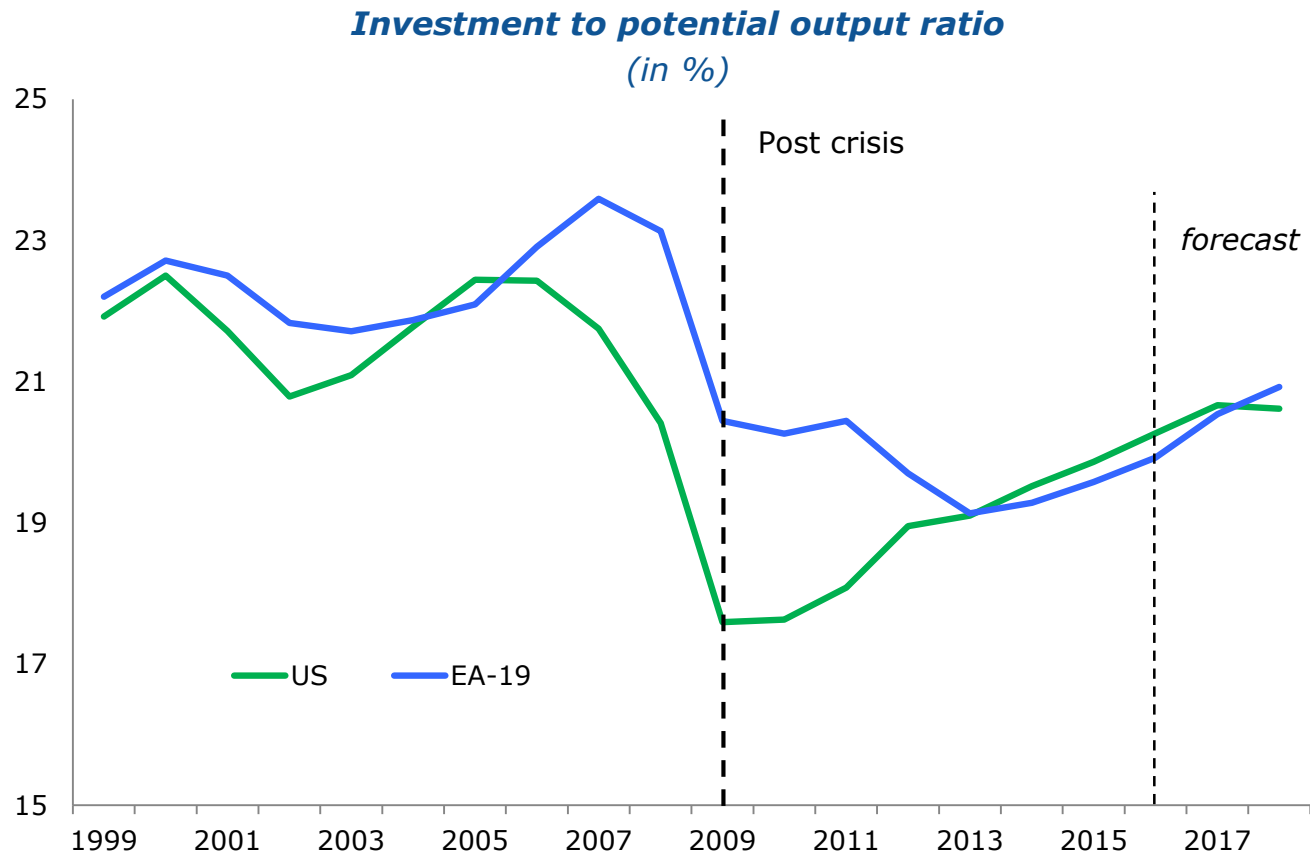
Source: DG-ECFIN calculations based on OECD data.

Labour and product market rigidities contributed to weak labour market performance in the EA



Source: All indicators taken from Ameco except for the product market rigidity measure, which comes from the OECD.

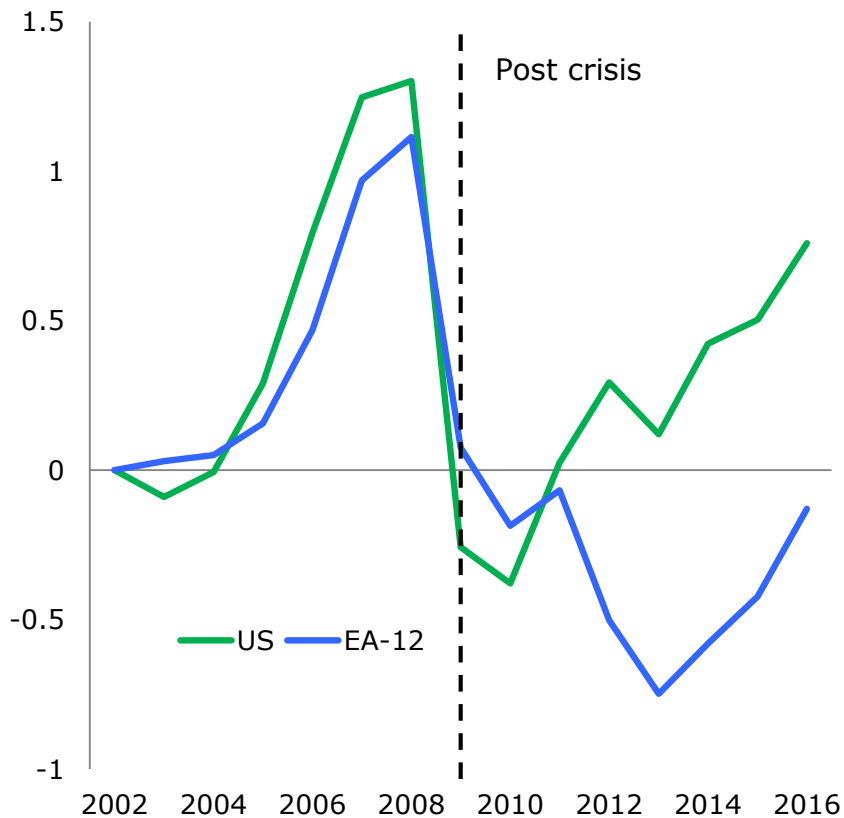
Sluggish investment: both in the EA and the US



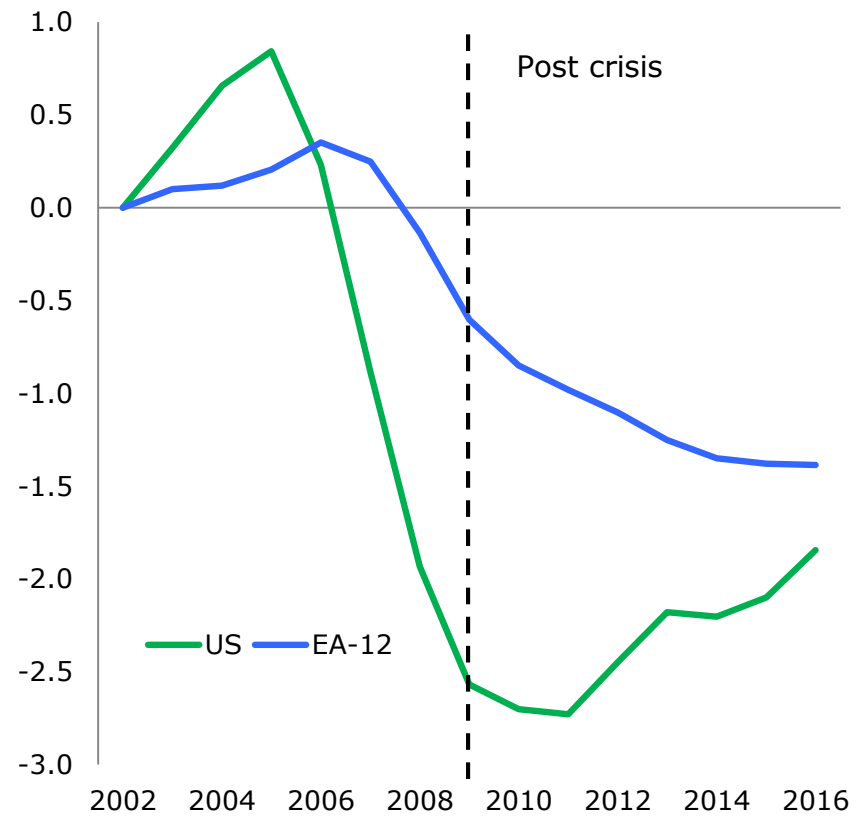
Source: DG-ECFIN calculations, Winter Forecast 2016.

Weak investment: not exclusively driven by housing investment

Total investment except housing
(% of GDP, rescaled 2002=0)



Housing investment
(% of GDP, rescaled 2002=0)



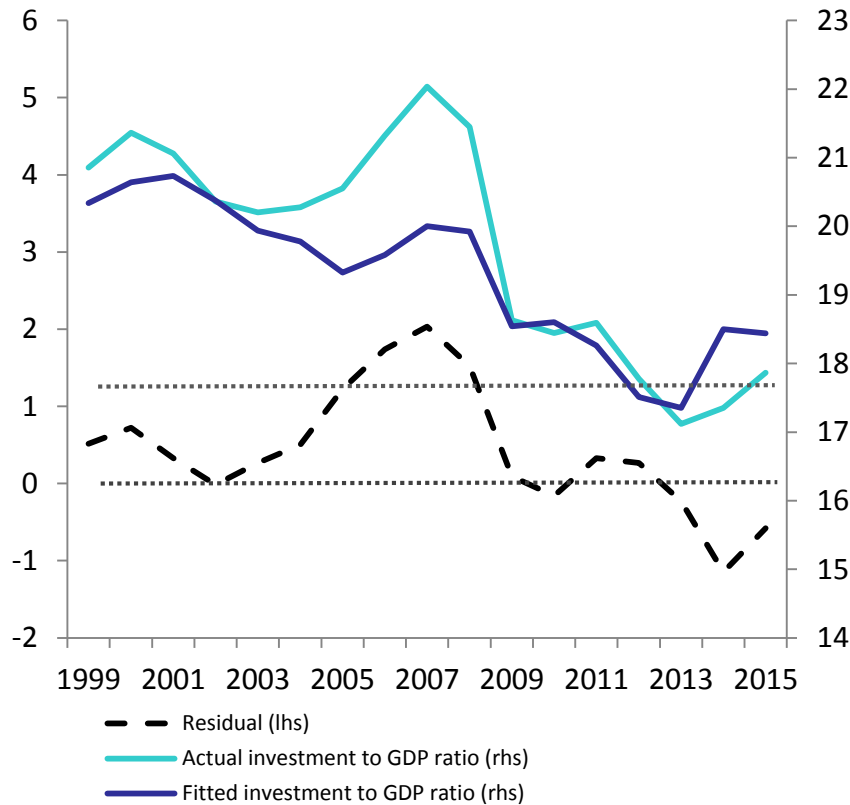
Source: OECD.

Weakness in investment: both cyclical and structural factors at work

- Sluggish economic growth (the so-called 'accelerator channel')
- Deleveraging and reduction of overcapacity
- Regulatory and non-regulatory bottlenecks
- Decline in public investment
- Financial fragmentation
- Economic uncertainty

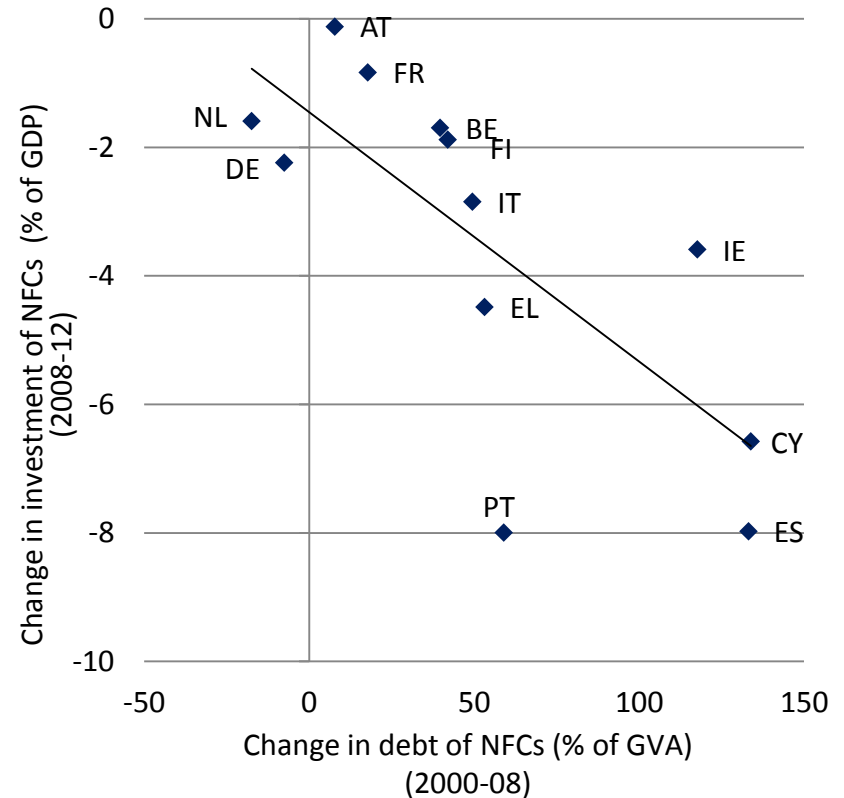
Key drivers of weak investment are: low growth and high deleveraging needs ...

Investment regressions using the accelerator model for the Eurozone



Source: European Commission. Estimations based on an EA-12 sample using real gross fixed capital formation to GDP ratios.

Non-residential investment and non-financial corporations' debt

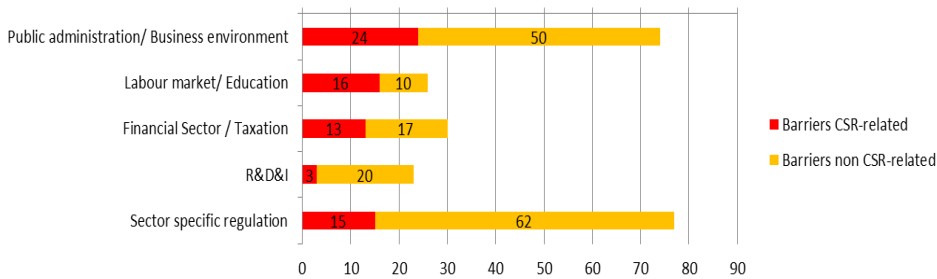


Source: European Commission.

... sizeable barriers to investment and declines in public investment ...

Barriers to Investment - ALL Member States*

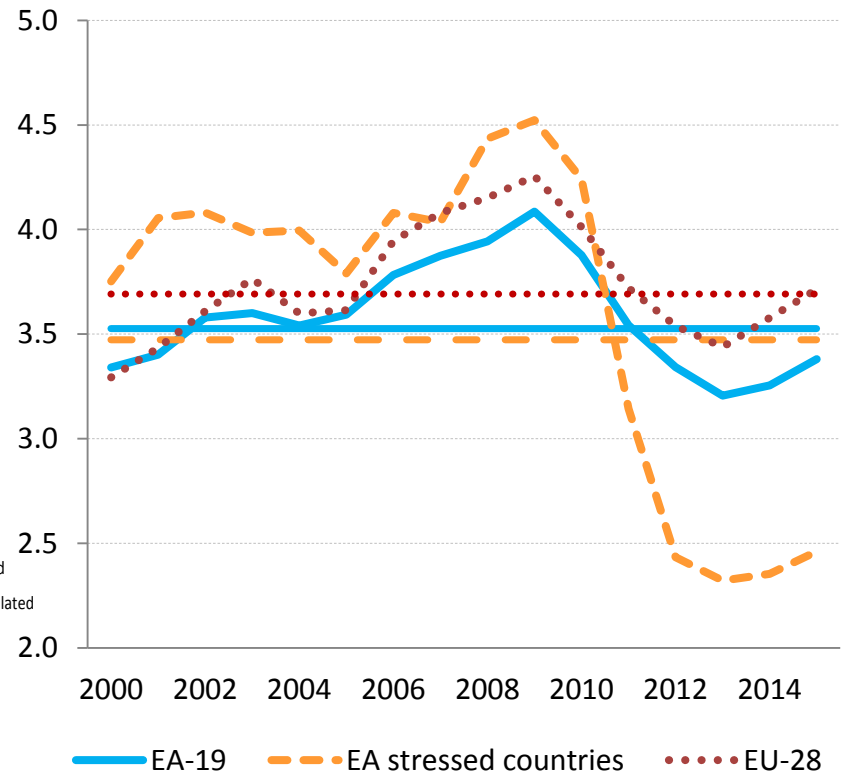
*CY and EL not included



Barriers to Investment - EA MS heavily hit by the crisis



Public investment
(% of GDP)



— EA-19 - - - EA stressed countries EU-28

Note: CSR stands for the "country-specific recommendations" issued by the European Commission as part of the European Semester.

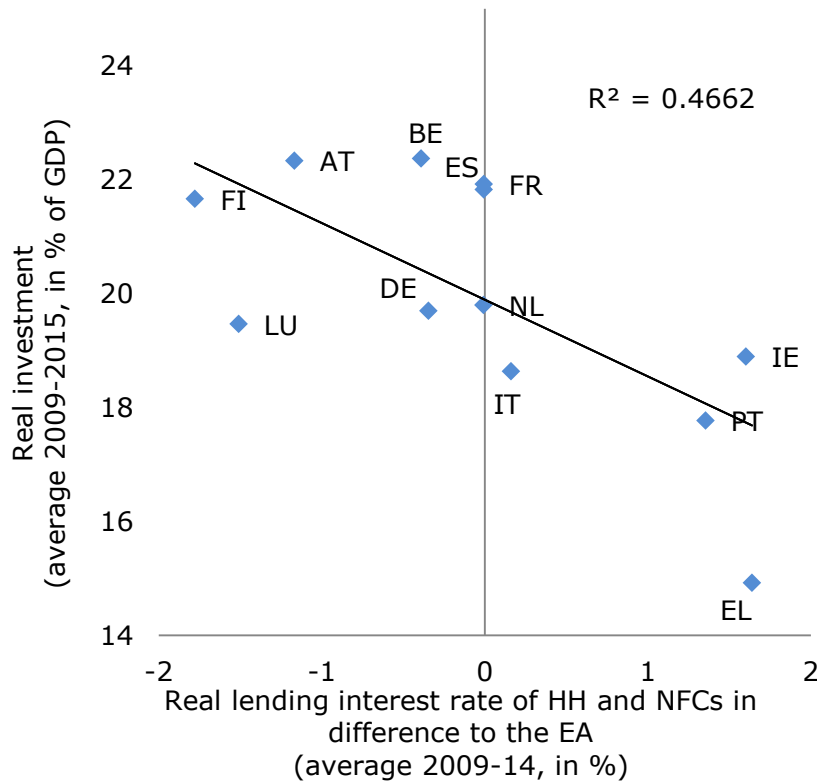
Source: European Commission, DG Ecfm.

Note: 'EA stressed countries' consists of CY, ES, GR, IE and PT. Group averages are calculated based on simple arithmetic averages. Data for Greece are only available from 2006.

Source: Own calculations based on European Commission 2015 Autumn Forecast.

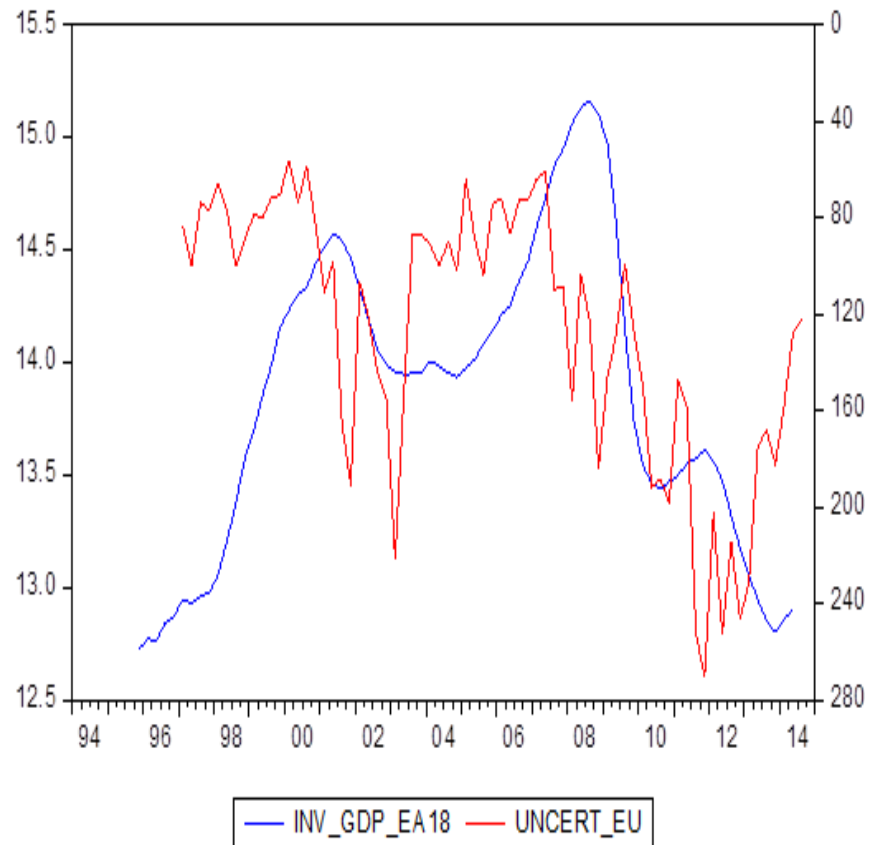
... high fragmentation and economic uncertainty

Investment and fragmentation



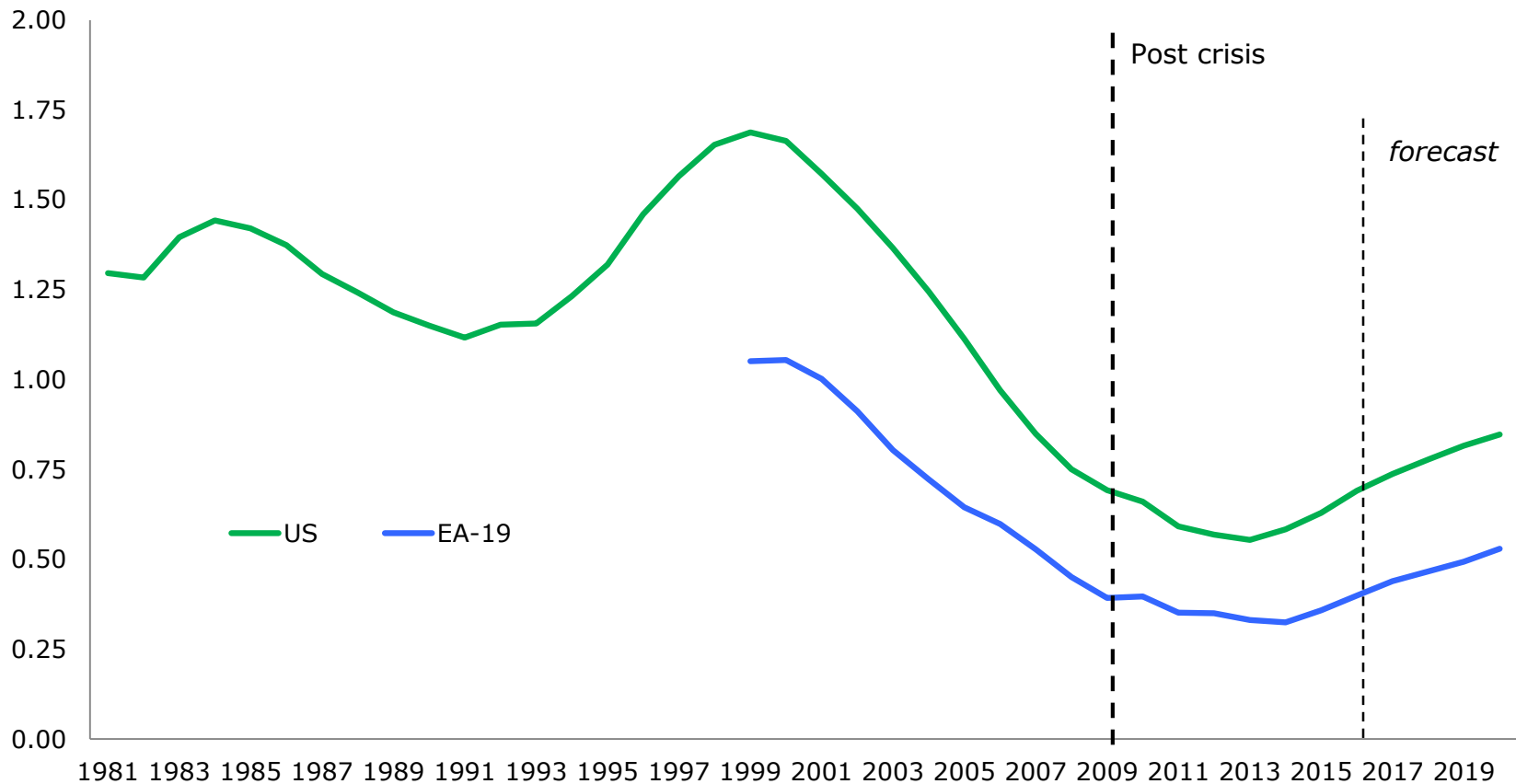
Source: European Commission. Estimations based on an EA-12 sample using real gross fixed capital formation to GDP ratios.

Investment and uncertainty



Source: Investment measured as gross fixed capital formation in percent of GDP.

TFP decline started already before the crisis, and affected both the EA and the US



Source: European Commission.

Substantial divergence in TFP growth across EA/EU countries

TFP trend growth differentials relative to the US

More convergence

Relatively strong trend growth

Increasing divergence

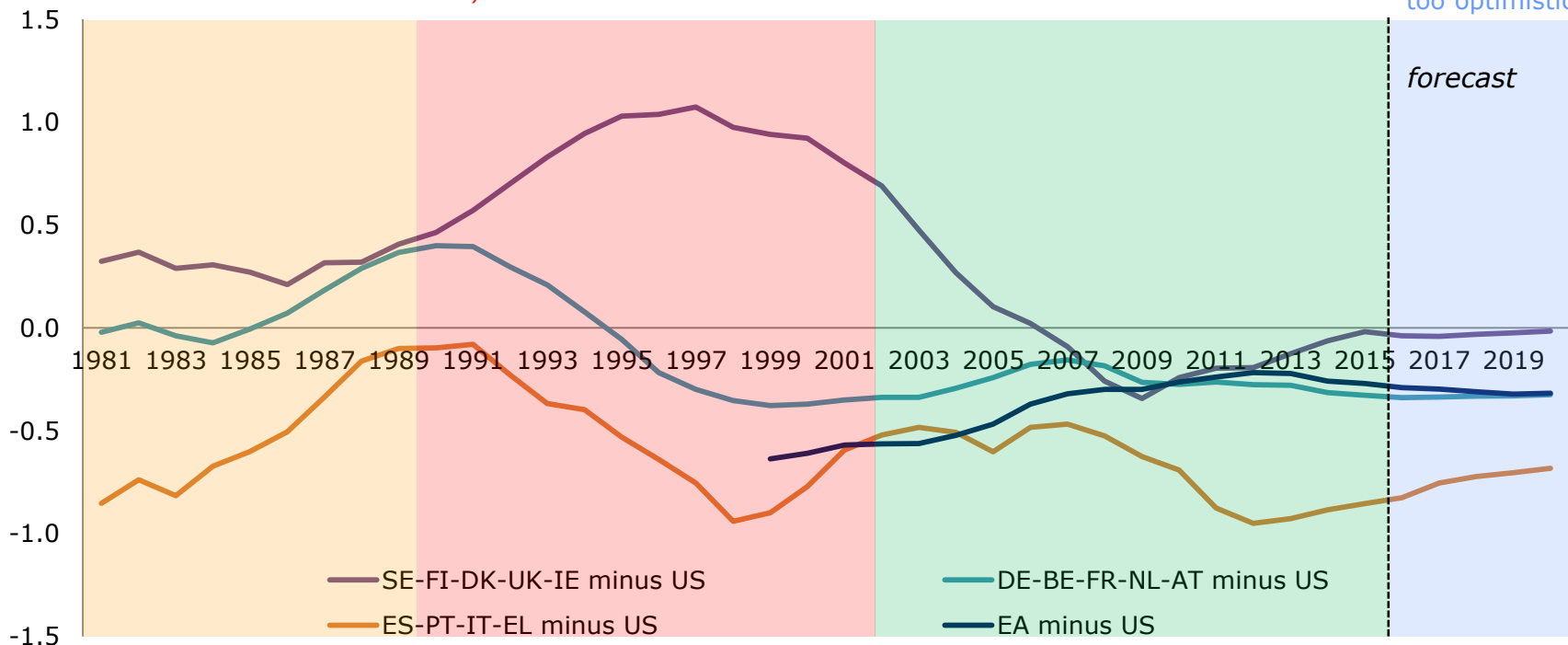
Mainly due to different abilities to absorb new ICT technologies (see e.g. Jorgensen et al. 2008, Inklaar et al, 2008)

Sluggish TFP levels

Mainly due to excess capacity in the EA (see e.g. Mc Morrow et al., 2016)

Convergence at low levels

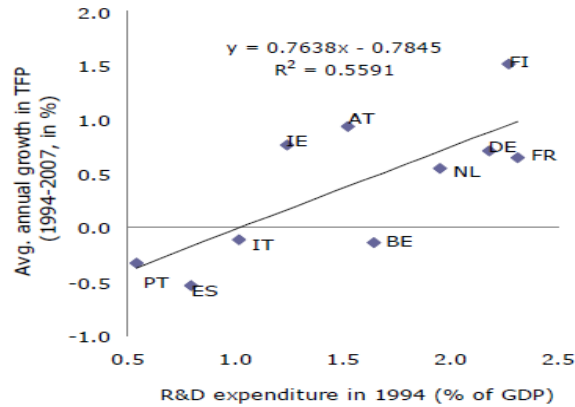
Forecast assumptions too optimistic?



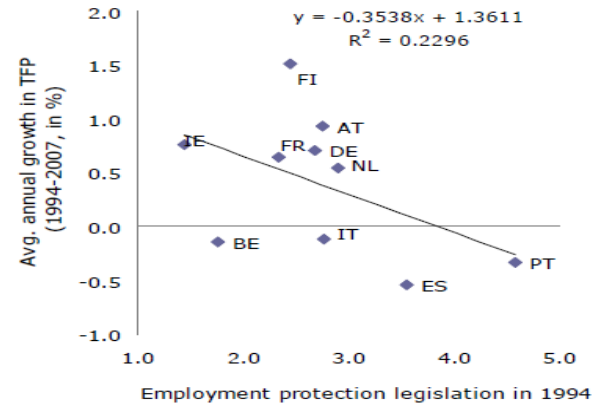
Source: Own illustration inspired by Mc Morrow et al. (2016): Medium term economic dynamics of the Euro Area, *International Economics and Economic Policy*, 13, 27-43.

How to increase TFP?

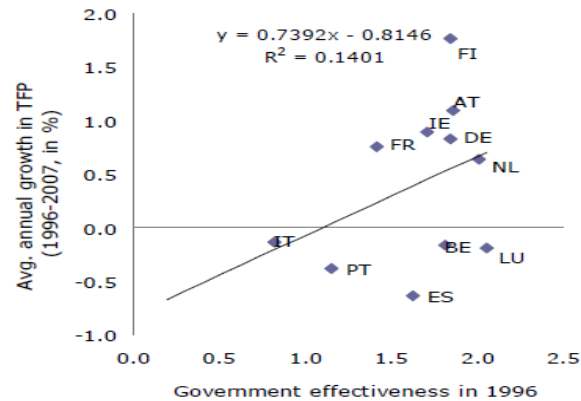
R&D spending



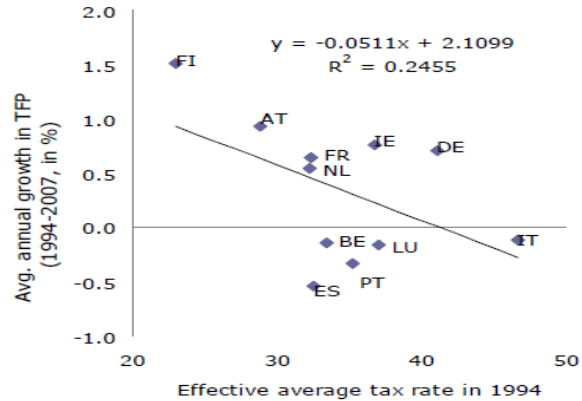
Employment protection legislation



Effectiveness of governments



Average effective tax rates

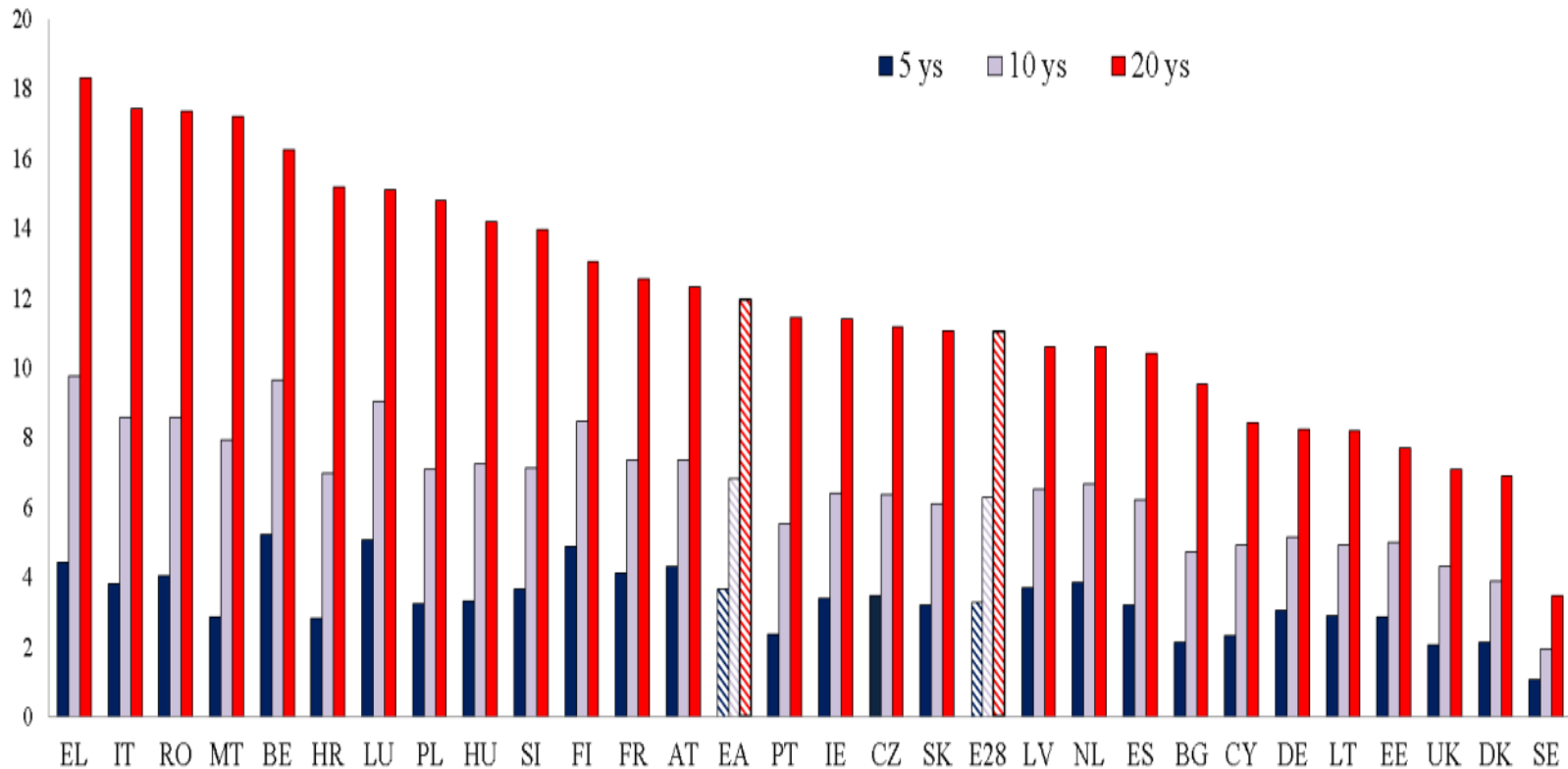


Note: Government effectiveness is measured with a WB indicator capturing perceptions of the quality of public services and the degree of its independence from political pressures and the credibility of the government's commitment to such policies.

Source: European Commission (2014): The drivers of total factor productivity in catching-up economies, Quarterly Report on the Euro Area, Vol. 13(1).

Structural reforms to significantly lift growth potential

GDP effects closing half the gap with best practice



Source: Varga and in't Veld (2014): The potential growth impact of structural reforms in the EU. A benchmarking exercise, European Economy. Economic Paper No. 541.

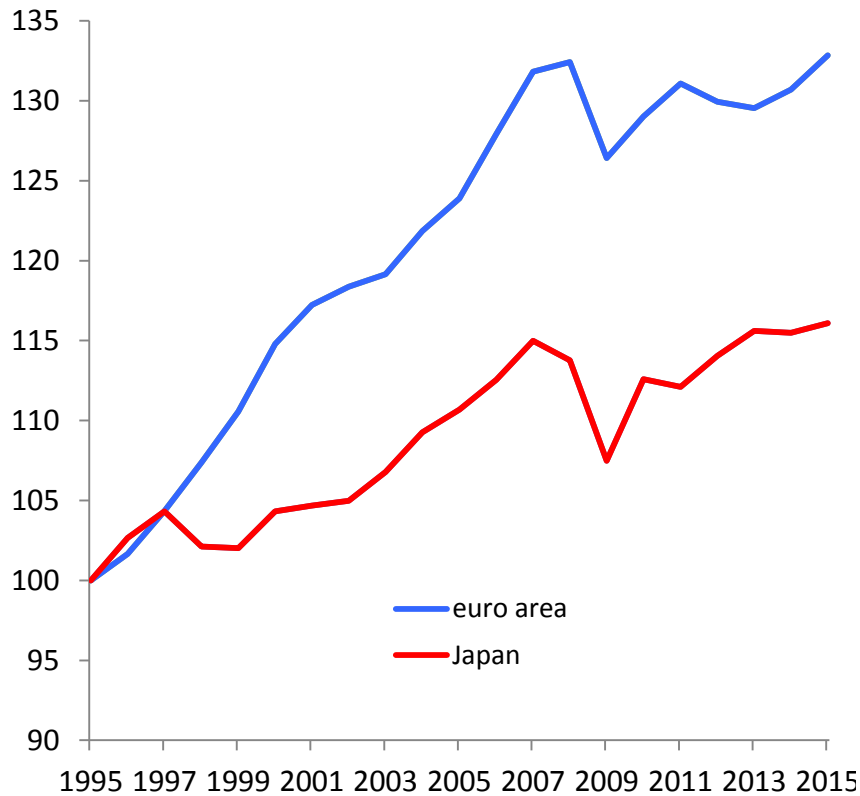
Decomposition of real GDP growth in the EA and the US

	EA	US
TFP	-3.8	0.7
Fiscal	-0.5	-0.7
Monetary	0.8	0.8
Price Mark-up	0.8	-1.2
Wage Mark-up	-0.5	-0.9
Private savings shock	-0.1	0.1
Investment risk premium	-2.2	-2.7
Trade and foreign shocks	0.4	0.9
Others	0.3	0.4
<i>Total deviation from log-linear trend</i>	-4.7	-2.7

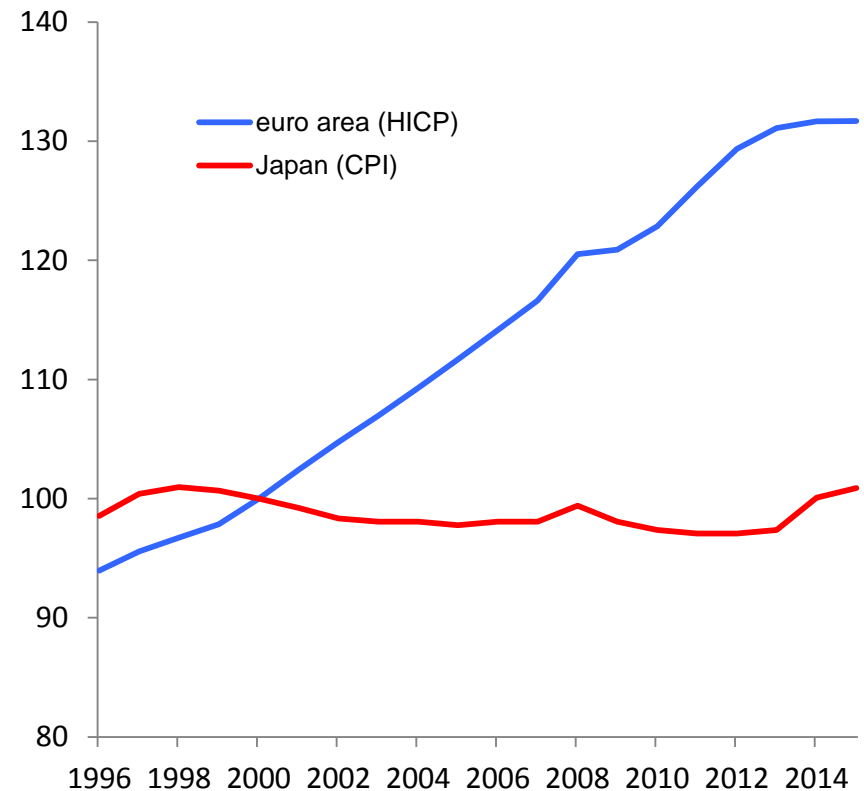
Source: Kollmann et al. (2016): The post-crisis slump in the Euro Area and the US: Evidence from an estimated three-region DSGE model, ECARES working paper, February 2016.

Japan underwent a long period of low growth and deflation

Real GDP
(Index: 1995=100)



HICP and CPI
(Index: 2000=100)



Source: Sources: Eurostat, IHS Economics, Statistics Bureau, Ministry of Internal Affairs and Communications.

Key features of the long period of stagnation in Japan (I)

- **Domestic**

- Burst of the asset-price bubble in the early 1990s
- Bank restructuring was delayed, whilst bank lending continued to be misdirected into so-called "zombie" firms
- 2011 Great East Japan earthquake

- **External**

- 1997-98 Asian financial crisis
- 2008-09 global financial crisis

- **Structural**

- Population ageing triggered a long-term decline in domestic demand and sluggish TFP growth (notably in the SME sector)
 - Potential growth declined steadily from over 3% in the early 1990s to around 0.7% in 2014
 - Less fiscal buffers together with governance flaws

In 2015, nominal GDP grew by 2.5%, but was still 4.6% lower than in its peak in 1997.

Key features of the long period of stagnation in Japan (II)

- **Fiscal policy**

- High budget deficits over the last 23 years [6% of GDP on average]
- Whilst the response to the early-90s crisis entailed an increase in public investment to 9% of GDP in 1996, long-term growth in social security expenditure and insufficient revenue growth account for a gradual deterioration in the state of public finances
- World's highest gross debt-to-GDP ratio of 270.8% in 2014 (74.6% in 1990)

- **Prices**

- Persistent deflationary pressures: long period [1995 to 2012] of negative CPI inflation [-0.1% on average] and GDP deflators [-1.1% on average]

- **Monetary policy**

- Almost three years of QQE, entailing an expansion of the balance sheet of the Bank of Japan to 76% of GDP

Will the Euro Area become the "next Japan"?

Key factors of low growth and deflation in Japan		Risk for the EA	
		in 2009?	in 2016?
Domestic	Burst of asset-price bubble	Red	Green
	Delayed bank restructuring	Red	Red
External	Financial crisis in neighbouring countries	Red	Yellow
Structural	Decline in working age population	Yellow	Yellow
	Sluggish TFP growth	Yellow	Yellow
Fiscal	Sizeable budget deficits	Red	Yellow
	Soaring public debt-to-GDP ratio	Red	Yellow
Prices	Long period of negative inflation	Green	Green
Monetary	Sizeable QE	Yellow	Green

Note: Green / orange / red stand for 'low' / 'medium' / 'high'.

Will the EA become the next JP? Currently unlikely

Commission medium-term baseline scenario assumes that EA will move back towards its pre-crisis growth rate, corrected for capital growth

	Real GDP growth (annual % change)	Potential growth (annual % change)	Contributions to potential growth (in pps.)		
			<i>Labour (persons)</i>	Capital accumulation	TFP
1999-08	2.2	2.0	0.4	0.8	0.8
2009-15	0.4	0.5	-0.1	0.3	0.4
2015	1.6	0.9	0.3	0.2	0.4
2016*	1.7	1.0	0.4	0.3	0.4
2017*	1.9	1.1	0.3	0.4	0.4
2018*		1.1	0.2	0.4	0.5
2019*		1.1	0.2	0.4	0.5
2020*		1.1	0.1	0.4	0.5

Source: DG-ECFIN calculations, 2016 Winter Forecast. Forecast horizon highlighted in grey.

Conclusion

- ❑ Slower recovery in the EA than in the US
 - Less supportive macroeconomic policies
 - Slower fixing of the banking system and more bank-centric economy
 - Less flexible economy
 - Different sequencing of policy response due to incomplete EMU architecture
- ❑ EA not the 'next Japan'
- ❑ Secular decline in potential growth in the EA (and the US)
 - Mainly driven by ageing, struggling capital deepening and anaemic TFP growth
 - Gap between US and EA potential growth due to differences in labour and TFP
- ❑ Going forward: Protracted period of moderate growth and low inflation
 - No secular stagnation but move towards lower equilibrium
 - New policy challenges: debt overhang; zero lower bound; social fabric
- ❑ Four-pronged policy strategy urgently needed, namely appropriate (i) monetary, (ii) fiscal, (iii) investment and (iv) structural policies