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The Future of Developed Economies after the Great Recession

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After the **Great Recession**

Fundación Cañada Blanch and University of Valencia, 28 March 2012

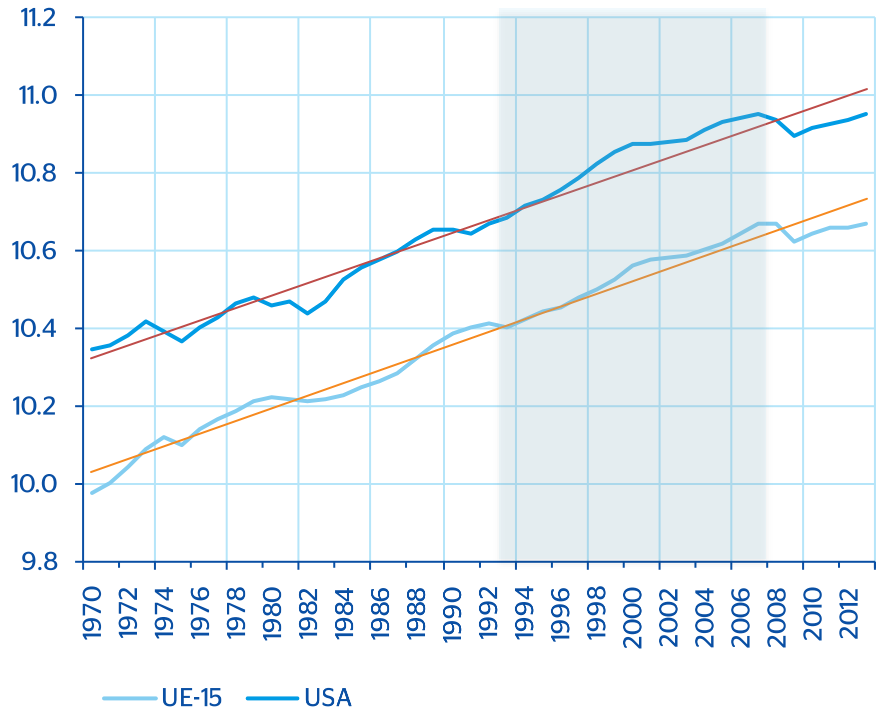
The future ain't what it used to be

Yogi Berra

From the Great Moderation to the Great Recession

GDP per working-age person (% y/y)

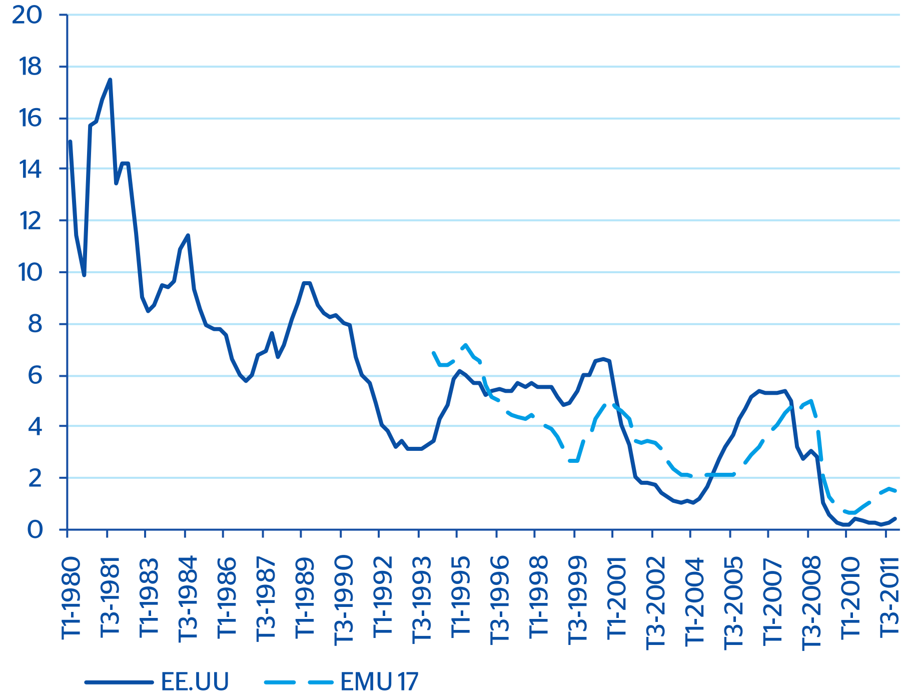
Source: BBVA Research



- From 1995 to 2007: one of the periods with the most economic growth
- Less volatile cycles and the perception that economic policy was better managed
- Low inflation rates
- Great moderation
- Risk perceived as extremely limited, and very low interest rates

1. Policy of low interest rates – or the "money glut"

Short term interest rates
Source: Main Economic Indicators, OECD



Rise of exporting countries with extremely low production costs

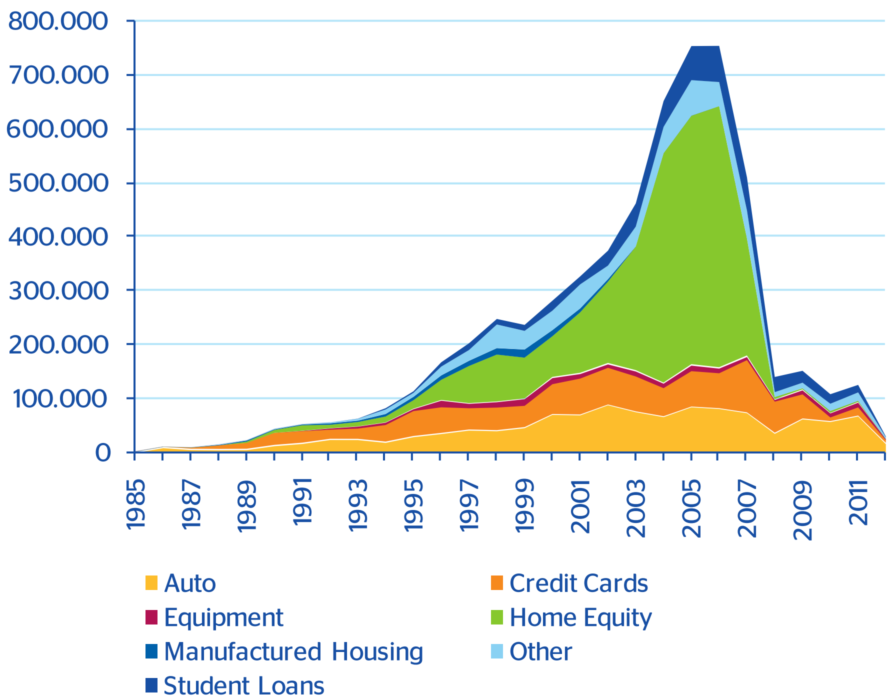
A policy of benign neglect towards high asset prices

A recession is avoided after the bursting of the Tech bubble and the reunification of Germany

2. High global savings rate or the "savings glut"

ABS issues (3 months, 2000-8)

Source: JP Morgan Chase and Adrian and Shin (2009)



Increase in demand for safe assets: substantial derivative and securitisation activity

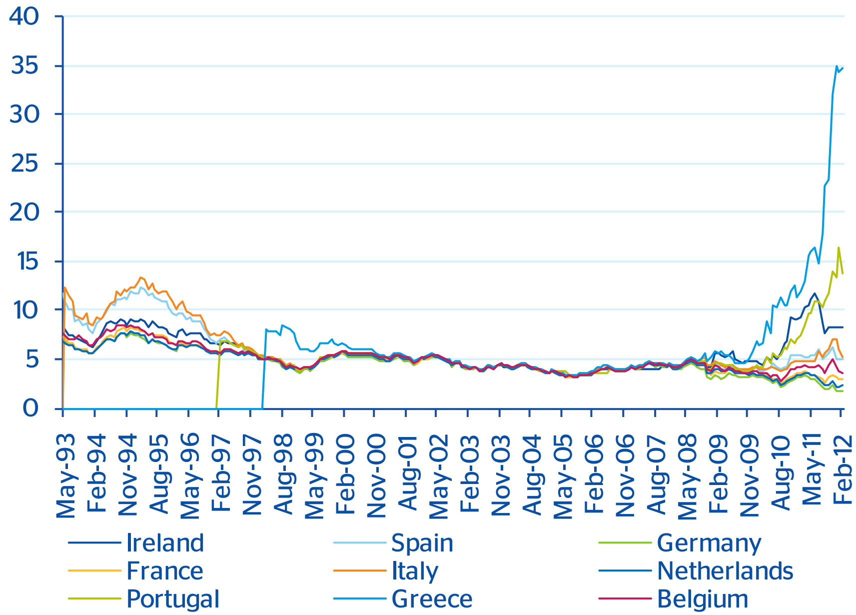
Massive amounts of liquidity to finance assets that serve as underlyings

Heteregeneity between countries, sectors and agents: savers vs. investors.

3. Creation of the EMU

Public debt interest rates, 10Y bonds

Source: Bloomberg and Adrian and Shin (2009)



Exchange rate risk disappears between members

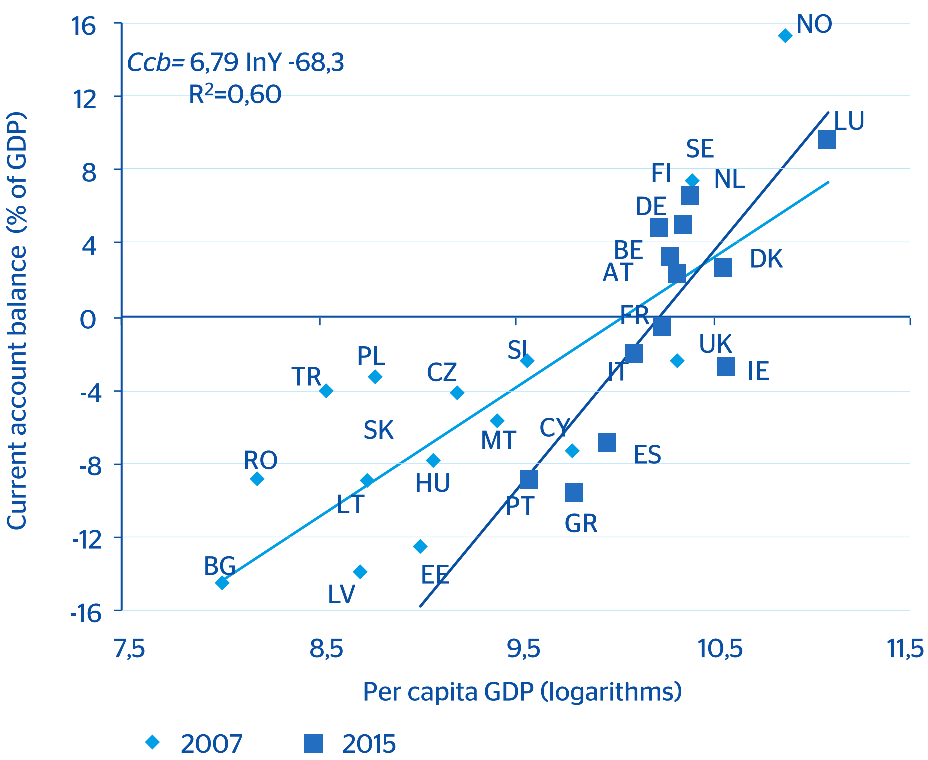
Expectations that EMU ensures economic convergence

Disappearance of the risk premiums for sovereign debt

3. Creation of the EMU

Per capita income and current account balance

Source: BBVA Research based on Eurostat



Economic convergence->capital flows

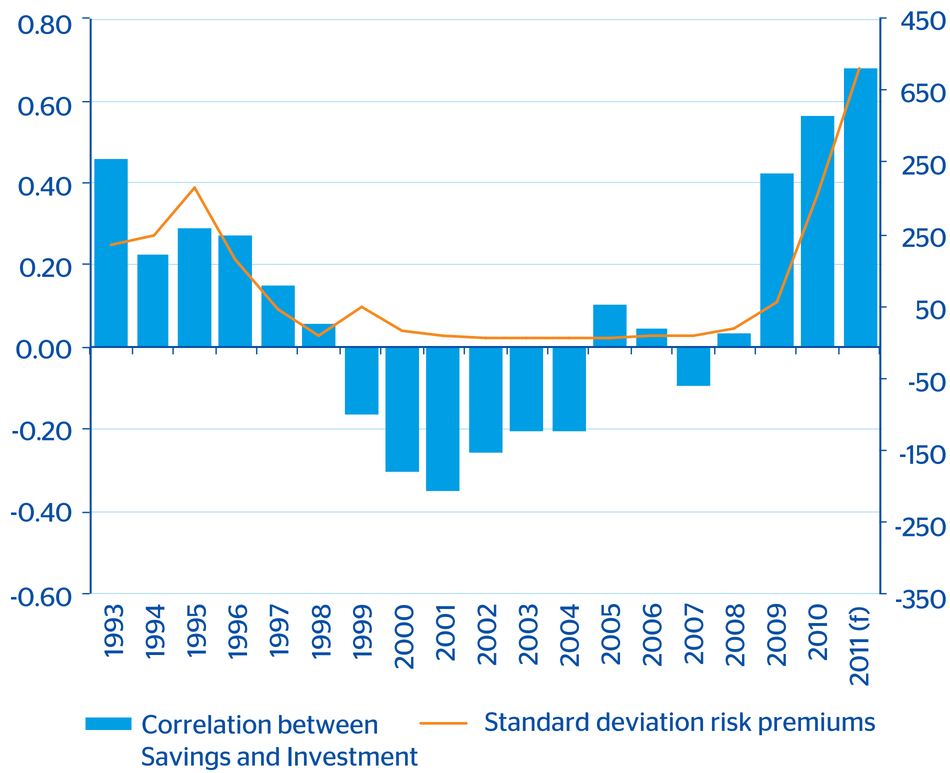
The current account balance reflects the expectations of economic convergence…

… in a much more intense manner in the EMU than in the rest of the EU countries.

3. Creation of the EMU

Correlation between the savings rate and investment and risk premiums

Source: BBVA Research based on Eurostat



Economic convergence -> capital flows

Disappearance of the Feldstein-Horioka paradox

The correlation between the savings rate and the investment rate goes to zero, or even negative

Imbalances in the EMU

Debt and deficits in the EMU, USA and the UK

(% of GDP)

Source: AMECO, Haver, IMF, national sources and BBVA Research

		EA17	US	UK
Aut. Reg, budget balance	2011	-4.4	-9.6	-8.9
Aut. Reg. Debt	2011	87.6	100.0	84.8
Household debt	2010	67,3	92,1	106,1
Company debt	2010	119.1	74.6	123.7
Current account balance	2011	0.1	-3.1	-2.7
Net international position	2010	-7.2	-17.0	-13.9

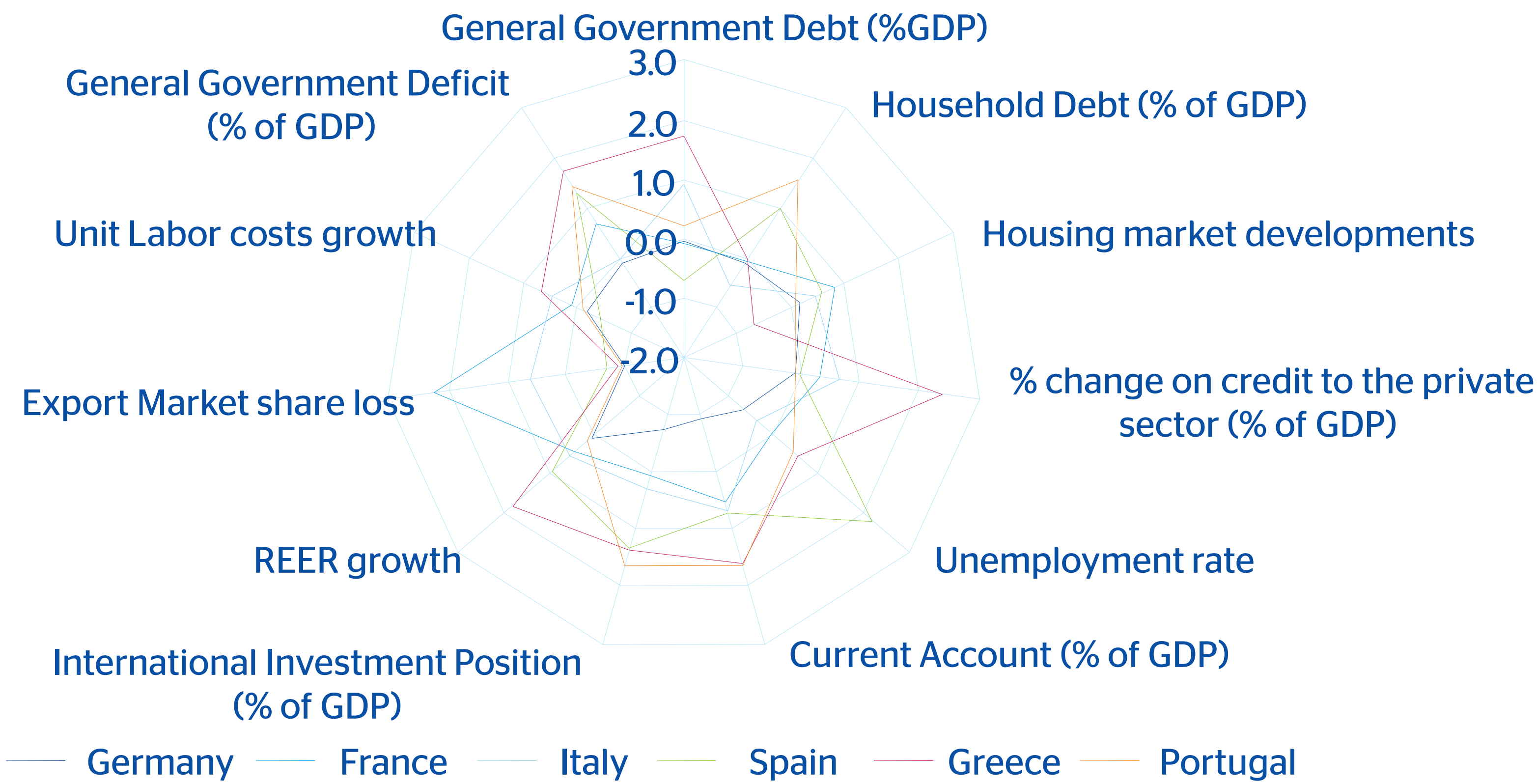
EMU has high degree of internal heterogeneity and fewer imbalances in aggregate…

… than in the USA or the UK…

… for the public sector, private sector and external sector

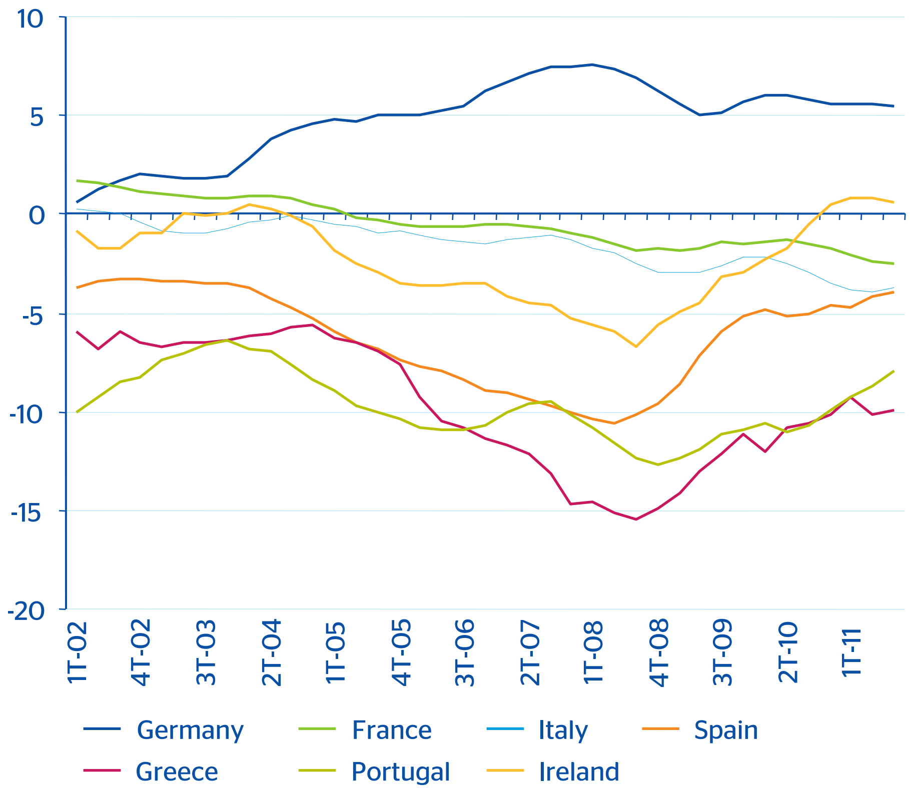
Imbalances in the EMU

Macroeconomic imbalances in the European periphery (six pack)
Index. Units of standard deviations with respect to the average in the Eurozone (Euro zone average= 0)
Source: BBVA Research, Eurostat and Haver



Imbalances in the EMU

Current account balance (% of GDP)
Source: BBVA Research with data from national sources



Progressive and sustained differences in current account balances of member countries

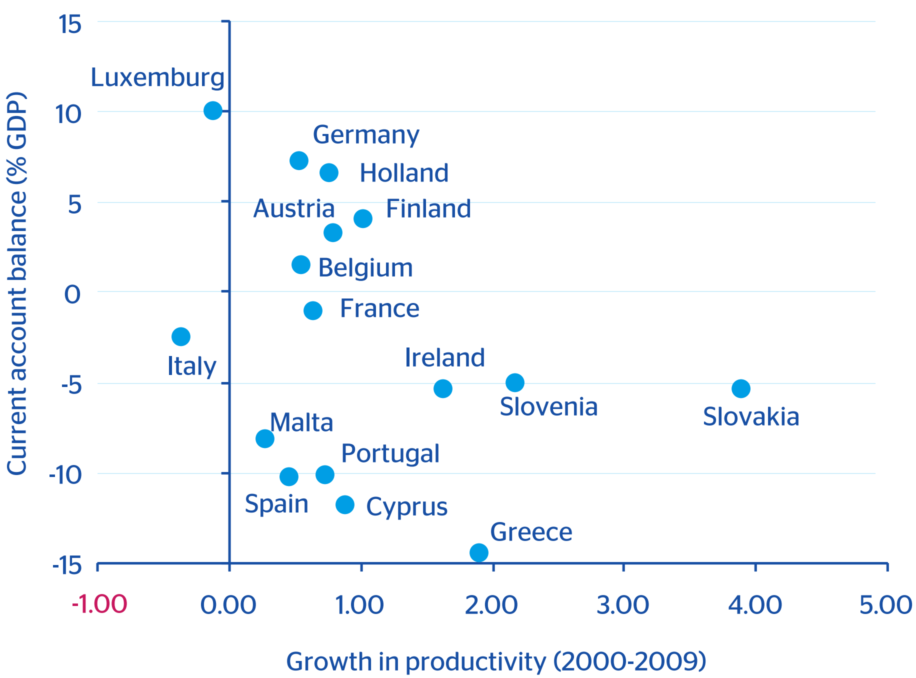
A savings rate that is considered optimal ("consenting adults", Obstfeld, 2012) ...

... that has triggered a *sudden stop*

Imbalances in the EMU

Current account balance and growth in productivity

Source: BBVA Research with data from national sources



Absence of correlation between external deficit and productivity growth

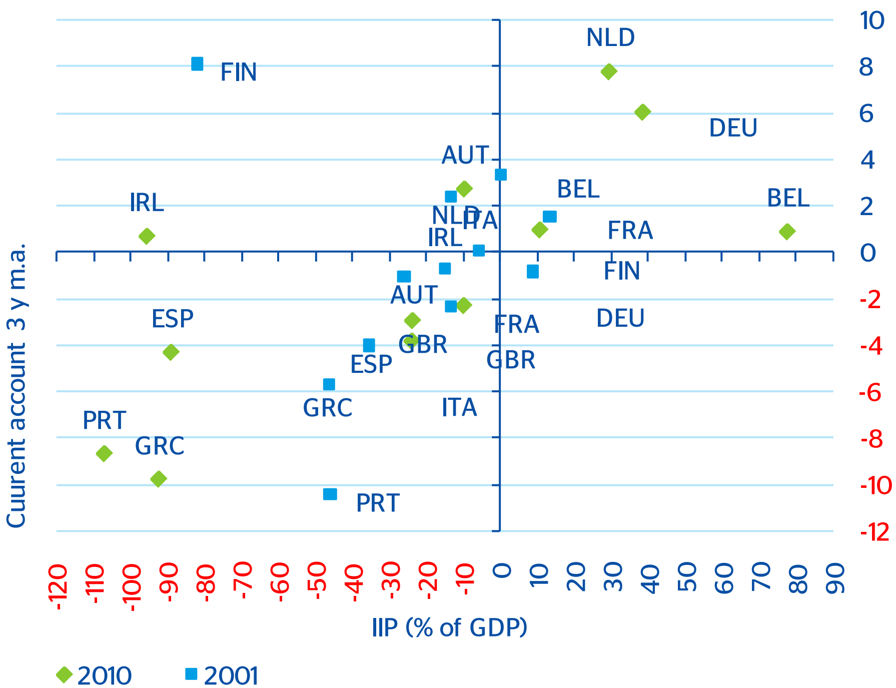
In some countries it was the decline in savings and in others it was excessive investment…

… with bank lending the main factor.

Imbalances in the EMU

Current account balance and net international position

Source: BBVA Research based on Eurostat



Sustained imbalance in current account balance

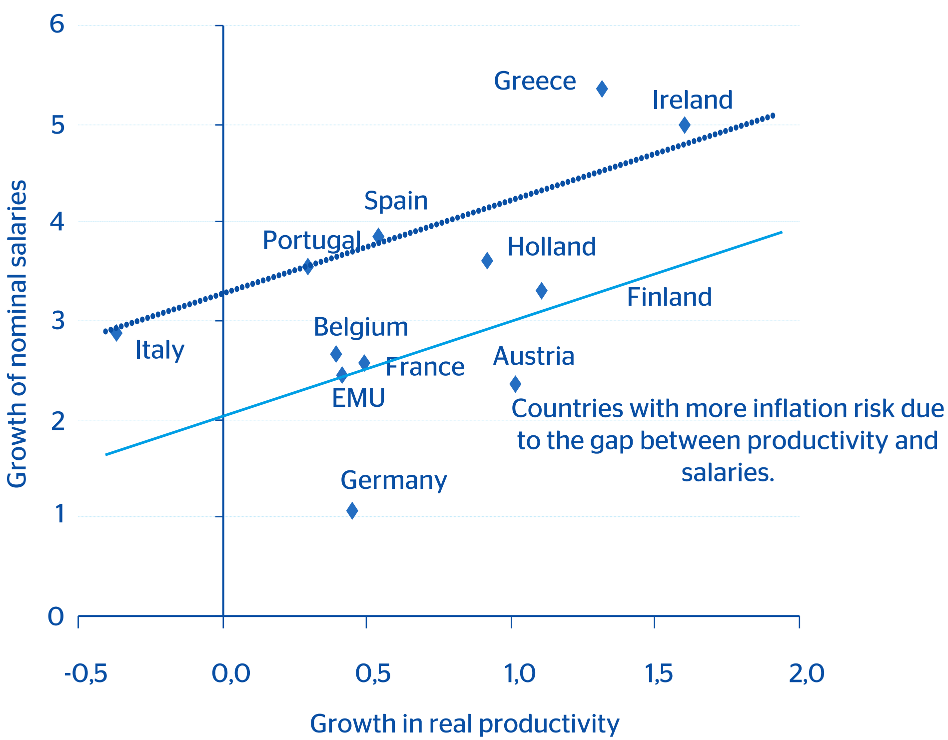
The savings/investment balance does not respond to net accumulated international position volume

High levels of net debt in countries such as Greece, Ireland, Portugal and Spain

Imbalances in the EMU

Nominal growth in salaries and real growth in productity

Source: BBVA Research based on Eurostat



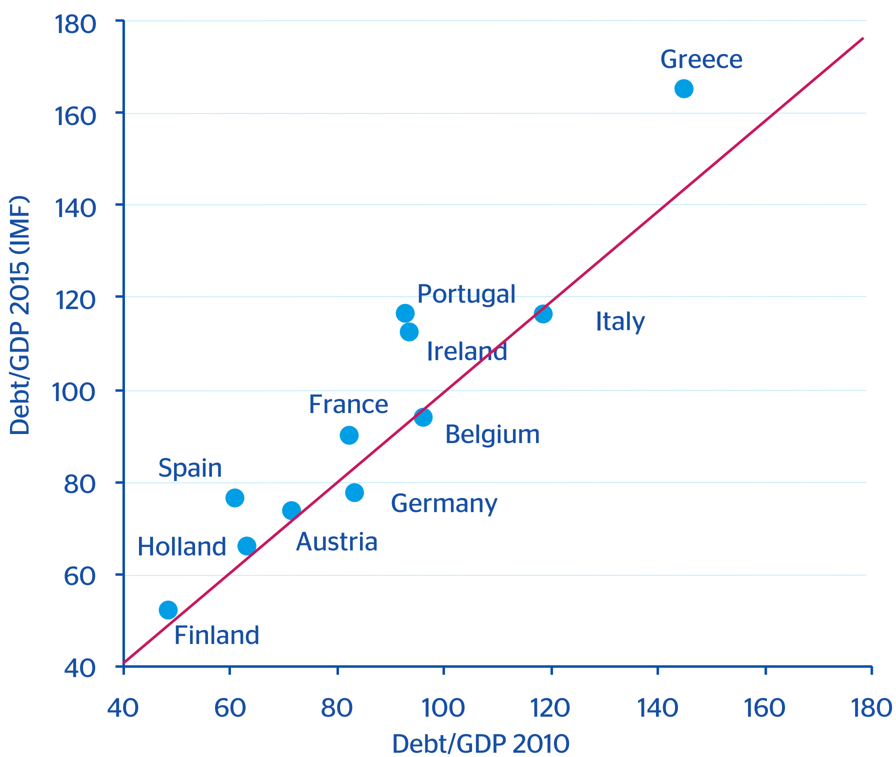
Market mechanisms have not functioned to correct these imbalances

External financing: production of non-tradable goods and increase in labour costs

Greece, Ireland, Portugal, Spain and Italy

Imbalances in the EMU

Public debt (% GDP)
Source: BBVA Research based on Eurostat



EMU debt less than that of USA and the UK…

… but with massive disparities between countries, which are growing in some cases.

Serious governance problems

Imbalances in the EMU

Macroeconomic imbalances in EMU (*six pack*)

Source: BBVA Research, Eurostat and Haver

	Belgium	Denmark	Gemany	Ireland	Greece	Spain	France	Italy	Holland	Austria	Portugal	Finland
Current acount	-0.6	3.9	5.9	-2.7	-12.1	-6.5	-1.7	-2.8	5	3.5	-11.2	2.1
Net IP	77.8	10.3	38.4	-90.9	-92.5	-89.5	-10	-23.9	28	-9.8	-108	9.9
Real exange rate	1.29	0.95	-2.95	-5.03	3.94	0.55	-1.41	-0.99	-0.98	-1.33	-2.43	0.26
Export share	-15.4	-15.3	-8.3	-12.8	-20	-11.6	-19.4	-19	-8.1	-14.8	-8.6	-18.7
ULC	8.5	11	6.6	-2.3	12.8	3.3	7.2	7.8	7.4	8.9	5.1	12.3
Home prices	0.38	0.6	-0.99	-10.5	-6.82	-4.27	3.61	-1.54	-2.86	-1.47	0.13	6.64
Private lending	13.1	5.8	3.1	-4.5	-0.7	1.4	2.4	3.6	-0.7	6.4	3.3	6.8
Private debt	233	244	128	341	124	227	160	126	223	166	249	178
Public debt	96.2	43.4	83.2	92.5	145	61	82.3	118	62.9	71.8	93.4	48.3
Unemployment	7.7	5.6	7.5	10.6	9.9	16.5	9	7.6	3.8	4.3	10.4	7.7

Imbalances in developed economies

Structural capacity in developed economies

Source: IMF and BBVA Research

	Liberal Market Economies			Coordinated Market Economies								Mixed market Economies				Avge.
Medium Term	UK	USA	IRL	GER	FRA	NLD	BEL	AUT	FIN	DEN	SWE	JAP	SPA	ITA	POR	GRE	
Labour market	1	1	1	2	3	2	2	2	1	1	2	1	3	3	3	3	1.9
Corporate regulations	1	1	1	2	2	1	3	2	2	1	1	2	3	2	2	3	1.8
Network regulations	1	1	3	1	2	1	1	1	2	1	1	2	1	2	2	3	1.6
Retail	1	1	1	1	2	1	3	3	2	2	1	1	2	2	2	3	1.8
Professional services	1	1	1	3	2	1	2	2	1	1	1	1	2	3	2	3	1.7
Long term																	
Institutions and contracts	1	2	2	1	2	1	2	1	1	1	2	2	2	3	3	3	1.8
Human capital	2	2	1	2	2	1	1	2	1	1	1	1	3	3	3	3	1.8
Infraestructure	1	1	3	1	1	1	2	2	2	1	1	1	1	3	2	3	1.6
Innovation	1	1	2	1	1	1	1	2	2	1	1	1	3	2	3	3	1.6
Average	1.1	1.3	1.7	1.6	1.9	1.1	1.9	1.9	1.6	1.1	1.2	1.3	2.2	2.6	2.4	3.0	1.7

Medium and long-term outlook

1. Reduction of imbalances accumulated during the expansion and the crisis

2. The new European governance and the future of euro

3. The relative position of the world's developed economies

1. Reduction in accumulated imbalances

A process involving deleveraging and reducing imbalances

Not all economies are the same…

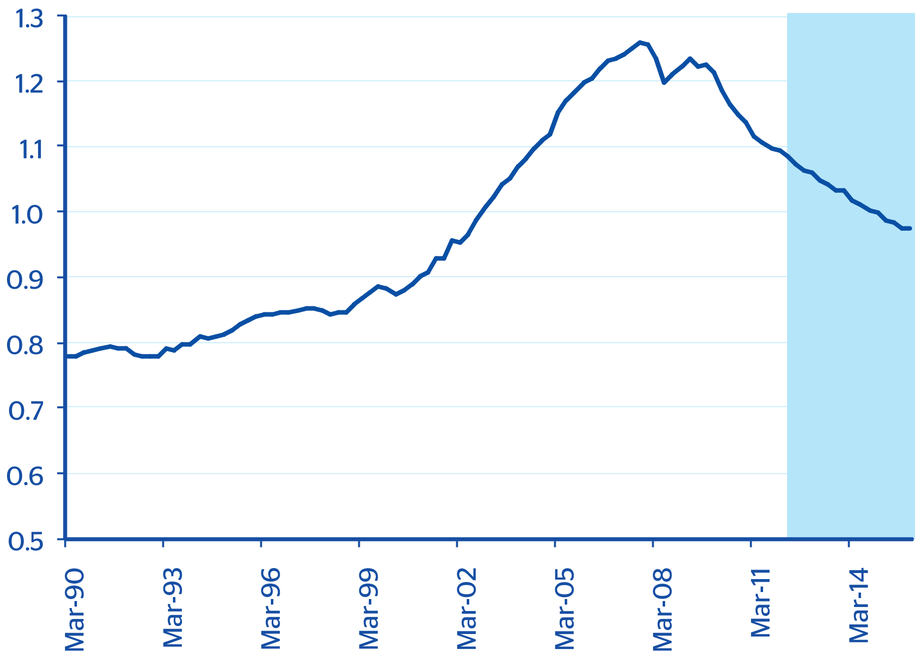
… some accumulate fewer imbalances in the expansion phase and…

… others start the adjustments much earlier and implement them more quickly (flexibility)

1. Reduction in accumulated imbalances

USA: Household indebtedness

Source: BBVA Research and Haver



In the United States, the adjustments are being made more quickly than in other countries

It benefits from a more flexible economy, with the capacity to correct imbalances more quickly...

... above all in the private sector, while the fiscal adjustment is still pending

Better outlook for potential growth

2. The new European governance

Supranational response to errors in coordination and mistakes made on the national level

1. Financial integration: supranational financial coordination and regulation

2. Fiscal integration: EU budget and temporary transfers

3. Economic integration: convergence in growth factors

2.1 Financial integration

It is difficult to manage a financial crisis without supranational regulators, supervisors and insurance mechanisms.

The US has federal institutions to manage the banking crisis. Europe does not

The US has federal regulation. Europe has a very widely dispersed regulatory regime that varies from nation to nation

Need to advance towards a common financial space

2.2 Fiscal integration

Agreement on Euro: Stability Treaty
EFSF+ESM and *six-pack*

Eurobonds: neither necessary nor sufficient, but convenient as an insurance mechanism

The proposal related to issuance of blue and red bonds has the advantage of maintaining market discipline.

¿Eurobonds -> European taxes?
Not necessary, except for redistribution

2.3 Convergence of per capita income

Financial and fiscal integration does not ensure economic convergence

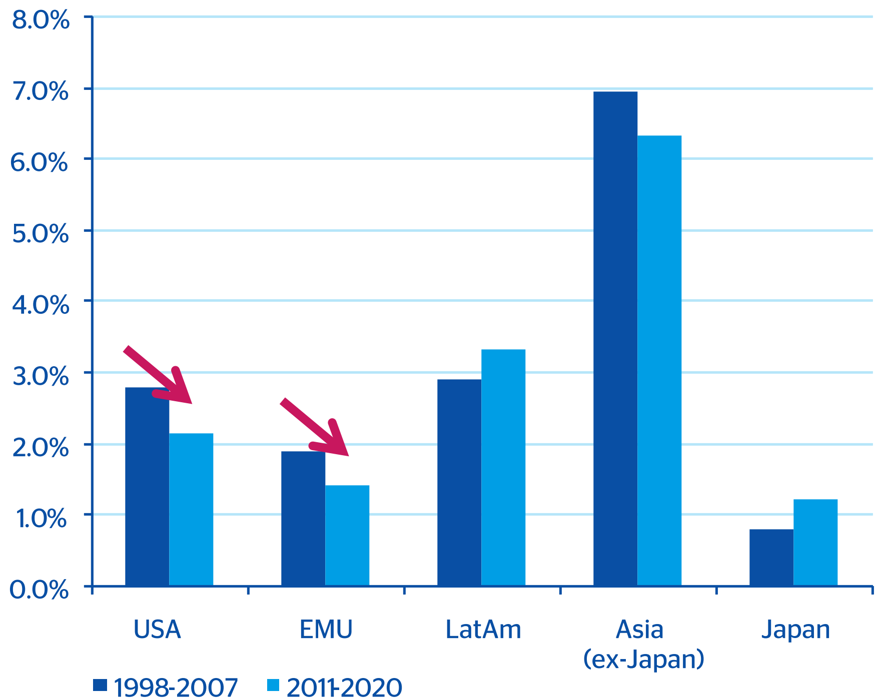
The benefits of the EU should go beyond financial and fiscal integration

It is necessary to facilitate the convergence of the factors that determine economic growth

A process that will take decades

3. Relative position in the world economy

Potential growth
Source: BBVA Research



Period of lower potential growth

Other highly important endogenous factors are generating a great deal of uncertainty

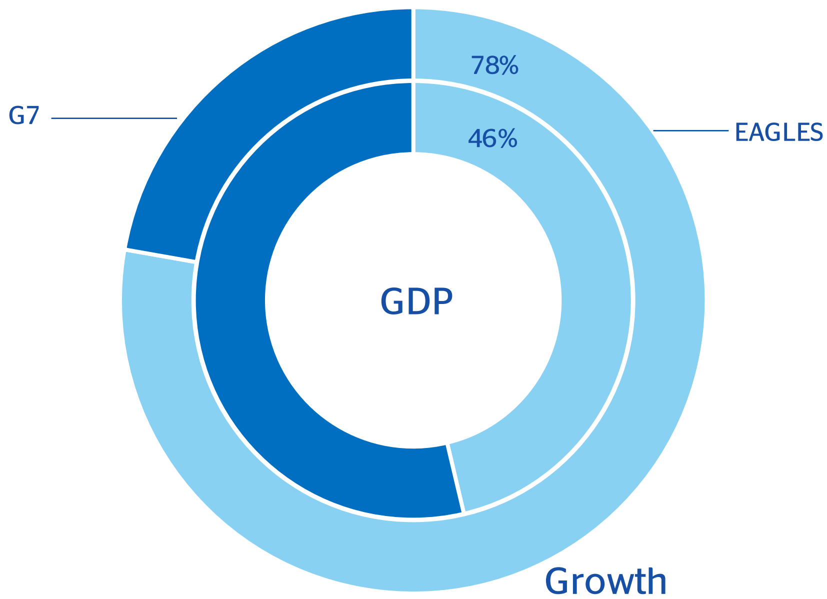
The deleveraging in the private sector will put the brakes on the accumulation of physical capital

Growth in the working-age population (aging, immigration) and human capital

Other structural reforms, sector changes and growth in TFP (competitiveness)

3. Relative position in the world economy

Current contribution to GDP and contribution to growth in the next decade
Source: BBVA Research



Developed economies are currently in a better position than where they will be in the future.

Taken together with the G7, the EAGLES (Emerging and Growth-Leading Economies) represent 46% of aggregate GDP...

... but will represent 78% of all growth in the next decade

Some economies (Korea) have already surpassed the per capita income of countries such as Spain.

Conclusions

1. Markets, agents, institutions, and governments have been excessively complacent in their interpretation of the imbalances generated during the expansion period
2. Markets overreact, are pro-cyclical and left to their own devices will not generate adequate disciplinary mechanisms in the short and medium term
3. The expansion and the crisis have generated serious imbalances that will detract from the economic performance of many developed countries for many years to come
4. Greater financial, fiscal, and economic integration to promote more balanced growth
5. The solution must entail structural and institutional reforms to speed up the recovery from the crisis and ensure enhanced long term welfare in a more competitive global economy

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