Policies to Avert Stagnation: The Crisis and the Future(s) of the Euro

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Some Simple Policies to Avoid Stagnation

- Stop Squeezing
- Halt Deflation
- Unblock Credit Channels
- Move beyond Structural Reform
- Build complete institutions

- Maastrict-Austerity -fiscal compact
- Monetary Policy Insufficient, Fiscal Policy Absent
- Means dealing with 1.2t Euro in NPLs
- Move to EU Wide fiscal and debt instruments
- Full financial union, common treasury etc.

And Why That's Not Going to Happen?

- Stop Squeezing
- Halt Deflation
- Unblock Credit Channels
- Move beyond Structural Reform
- Build complete institutions

- Ideological lock in/admitting failure/killing allies
- CB as only institution with region wide powers
- Who lends more in a recession?
- Necessitates region wide fiscal policy
- Not going to happen

But even if the political will was there, there's still two problems

Political Risk

- The problem of sustaining recovery in the face of counter-productive policy is multiplied when deflation becomes systemic

- **Result:** The hollowing-out of the party systems that have made the EU possible

Economic Risk

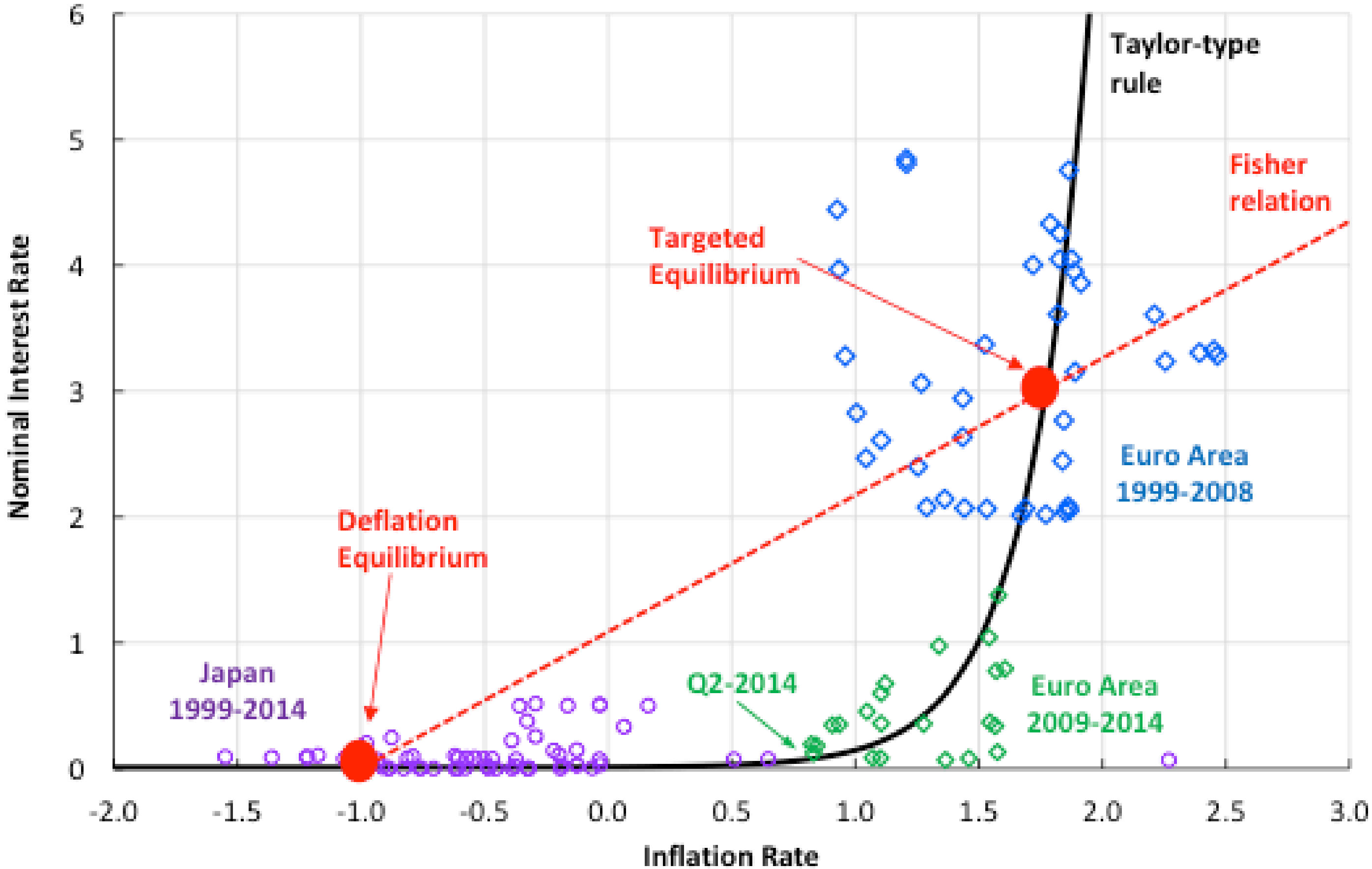
- The Eurozone recovery, to the extent that it exists, is predicated upon the EU as a whole running an export surplus against the RoW

- **Results:** Demand is external and fragile
- Sets different European 'Varieties of Capitalism' against each other

POLITICAL RISK: POLITICS IN A DEFLATION

There is a risk that the euro area is shifting from the targeted equilibrium to the deflationary equilibrium in which Japan became mired. The ECB has acted remarkably slowly to address this risk…

Interest rates, inflation, and multiple equilibria



Source: Antolin-Diaz (2014), "Deflation Risk and the ECB's communication Strategy", Fulcrum Research Paper

Where were were – and where we are now…

Inflation: The Debtor's Paradise of the 1970s

- Positive Inflation
- Labor's share of national income at all time high
- Corporate profits at all time low
- Unions Strong
- Low Inequality
- National Markets
- Finance Weak, Central Banks Weak, Parliaments strong

Deflation: The Creditor's Paradise of today

- Secular disinflation
- Capital's share at all time high, Labor at low point
- Collapse in wages
- Unions Weak
- Inequality high
- Globalized Markets
- Finance Strong, Central Banks Strong, Parliaments weak

Collective Action Under Inflation and Deflation

Inflationary Politics: Kalecki's Warning

- Capital's interests clear
- Labor on defensive and fragmented
- Neoliberal offensive at level of ideas and institutions
- State weakened, Finance Ascendant

- **Result**: Reagan, Thatcher, Blair, Cameron, Merkel

Deflationary Politics: Polanyi's Revenge

- Fallacy of Composition at the level of interest formation
- Anti-Creditor coalitions led by the state
- Creditor-Debtor stand-offs at the level of the state (domestic austerity) and internationally (EZ Crisis)

- **Result**: FN, Podemos, Syriza, SNP, Sinn Fein, UKIP, UK Labour

Deflation and Democracy: Who Wins and Who Loses in a Deflation?

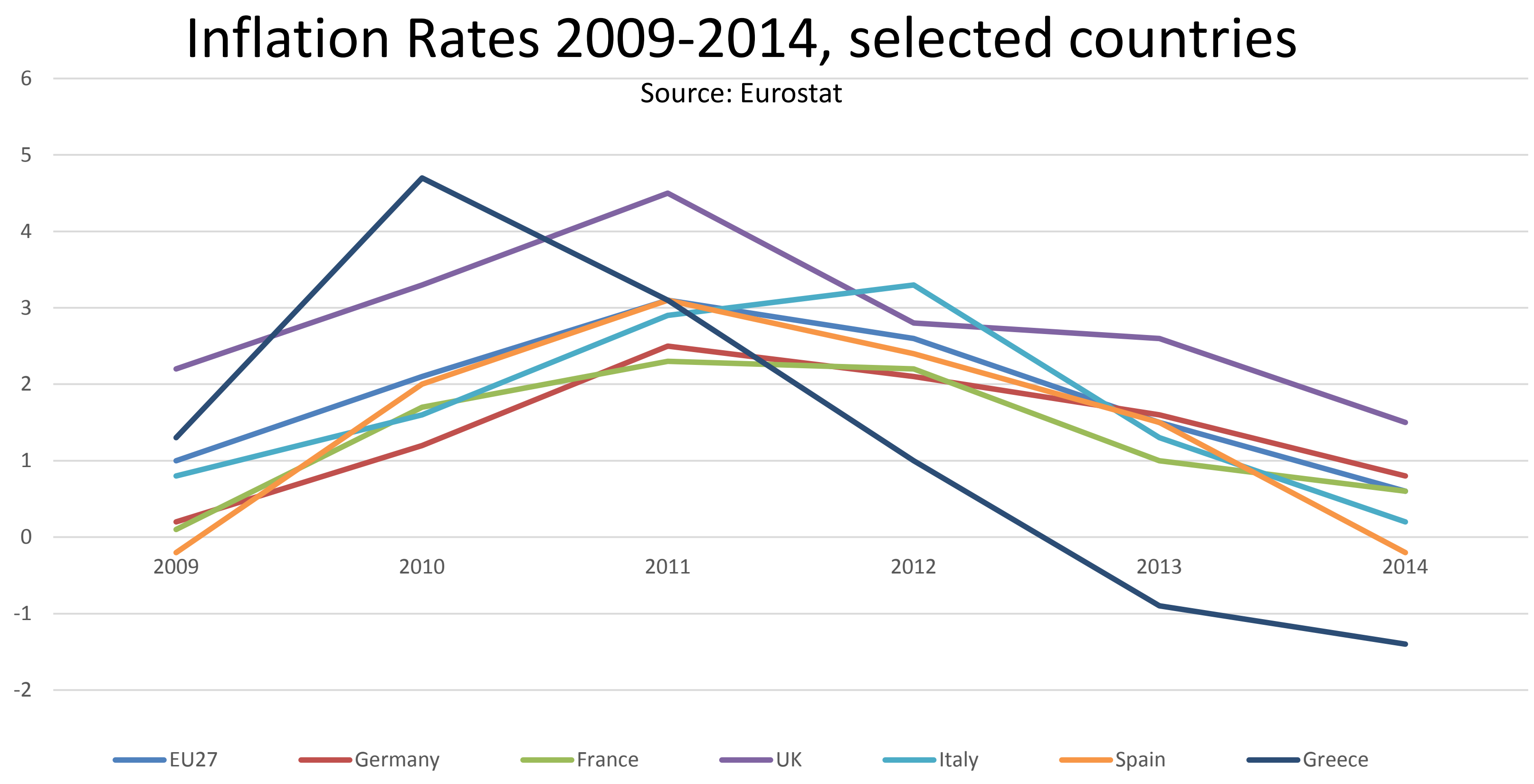
Losers

- **Creditors:** Real value of debt goes up but ability to collect goes down
- **Center Left Parties**: Vote share collapsing, new parties as mortal threat (Syriza bashing from the Left, Corbyn Phobia)

Winners

- **Debtors:** Can't pay - Won't pay – will vote
- **Populist and Nationalist Parties**: Renationalizing markets, anti-austerity coalitions

So what's the Inflationary Outlook for Europe?



And what that looks like for the Eurozone as a whole…

ECONOMIC RISK: LET’S EVERYONE RUN AN EXPORT SURPLUS!

Welcome to the post-crisis Eurozone export complex

EZ has a record trade surplus in last quarter of **€26.4 billion**

Germany, of course, has ***€24 billion of that surplus***

But that's also a bit misleading…

What really matters is who is importing what into the German supply chain…

The ‘New Europe’ of Export Parts-Supply, into Germany and out into the World

Percentage of Total Exports

- Czech Republic: 32 percent
- Austria: 29 percent
- Poland: 26 percent
- Hungary: 27 percent
- Slovenia: 20 percent
- Slovakia: 22 percent
- Romania: 19 percent

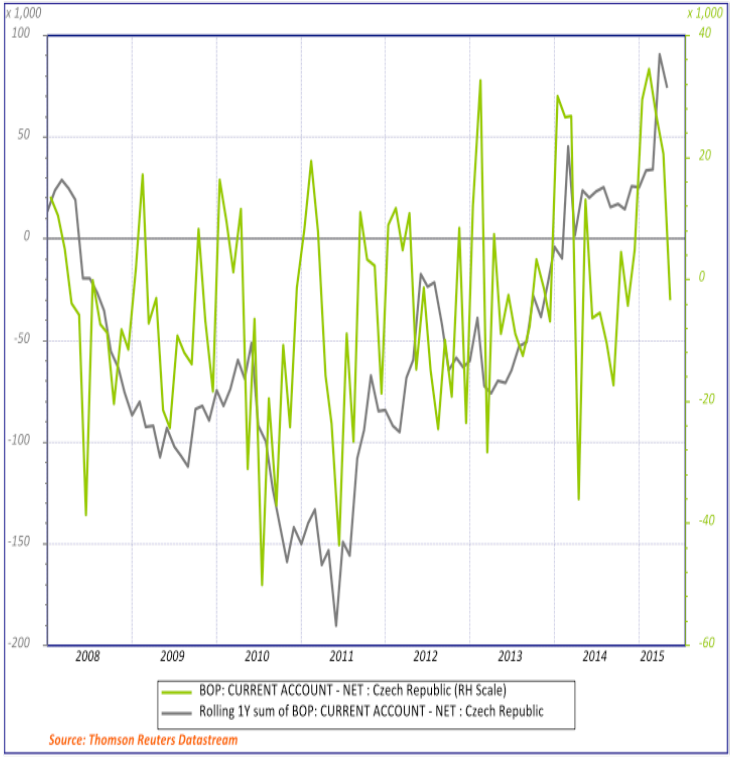
By Category (Vehicles, Bodies, Parts and Accessories)

- Czech Republic: 32 percent
- Austria: 34 percent
- Poland: 32 percent
- Hungary: 39 percent
- Slovenia: 28 percent
- Slovakia: 27 percent
- Romania: 27 percent

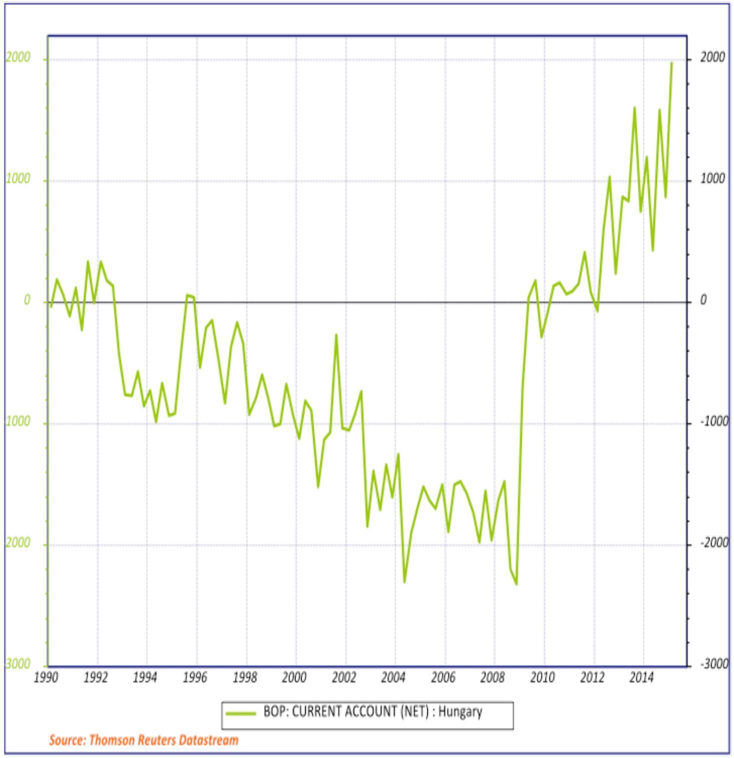
A FEW SUGGESTIVE CENTRAL EUROPEAN CHARTS

Central European Deficits become Surpluses

Czech Republic 2008-2015

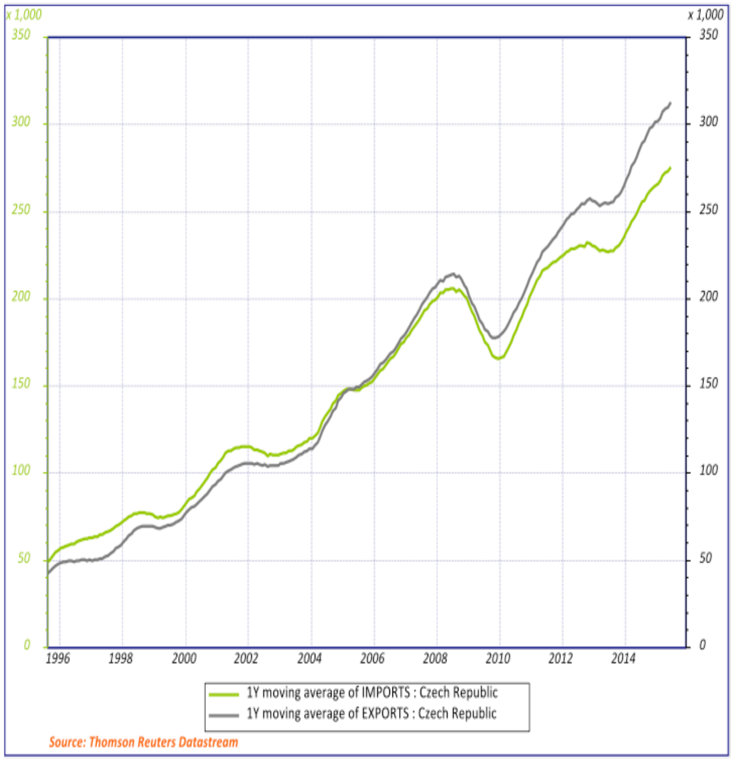


Hungary 2008-2015



Central European Exports overtake Imports

Czech Republic 2008-2015



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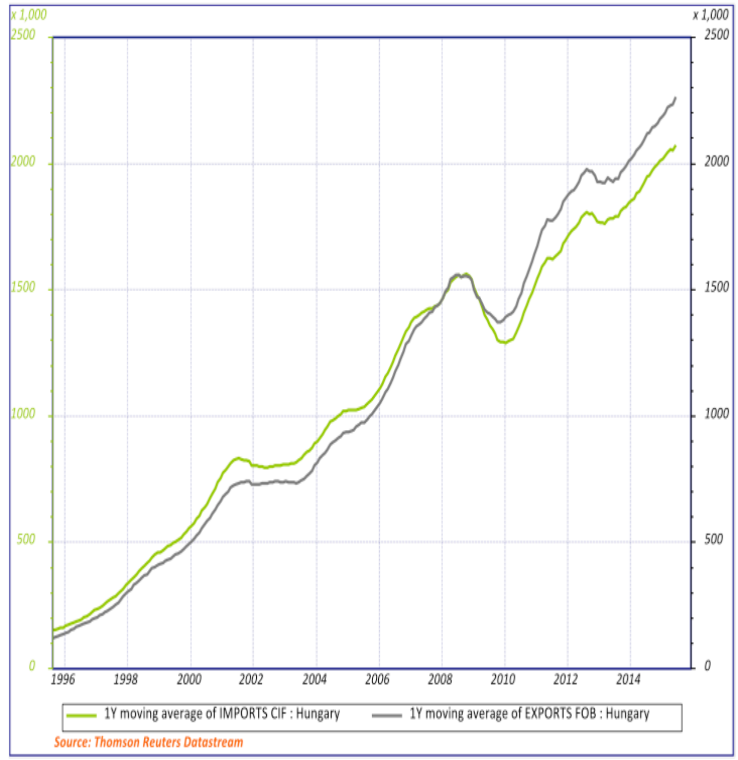
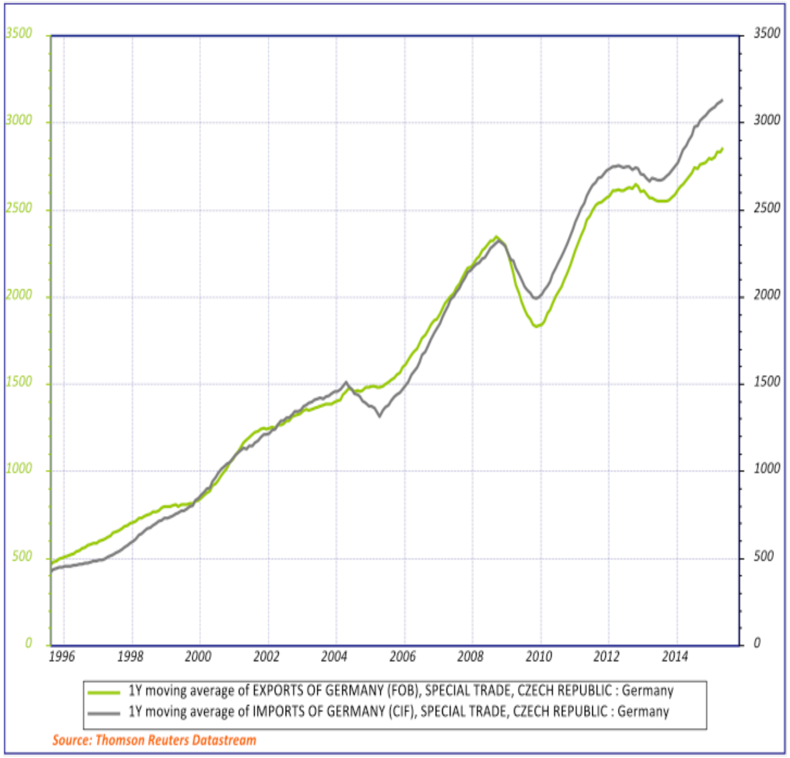
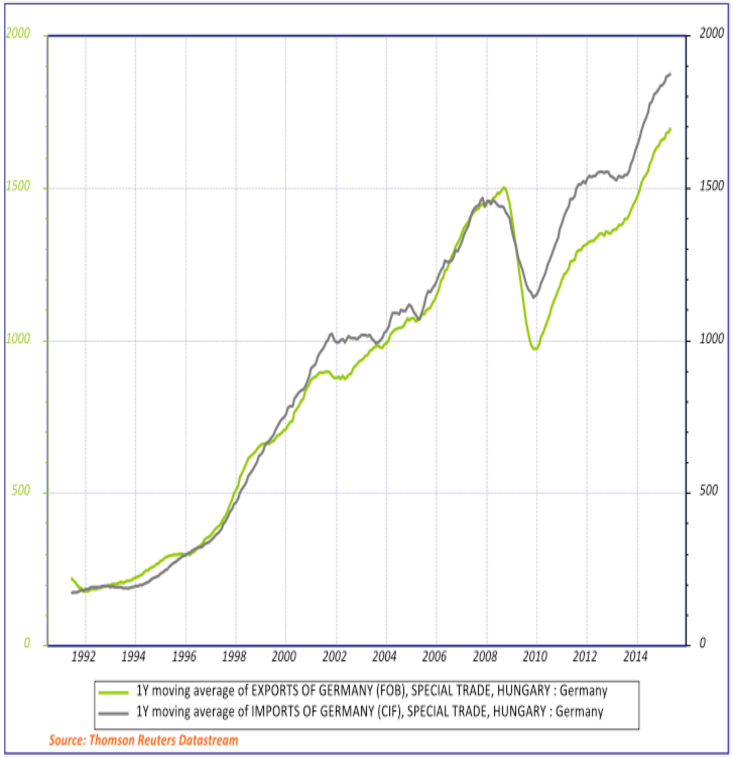


And of course, where so these exports end up? Germany

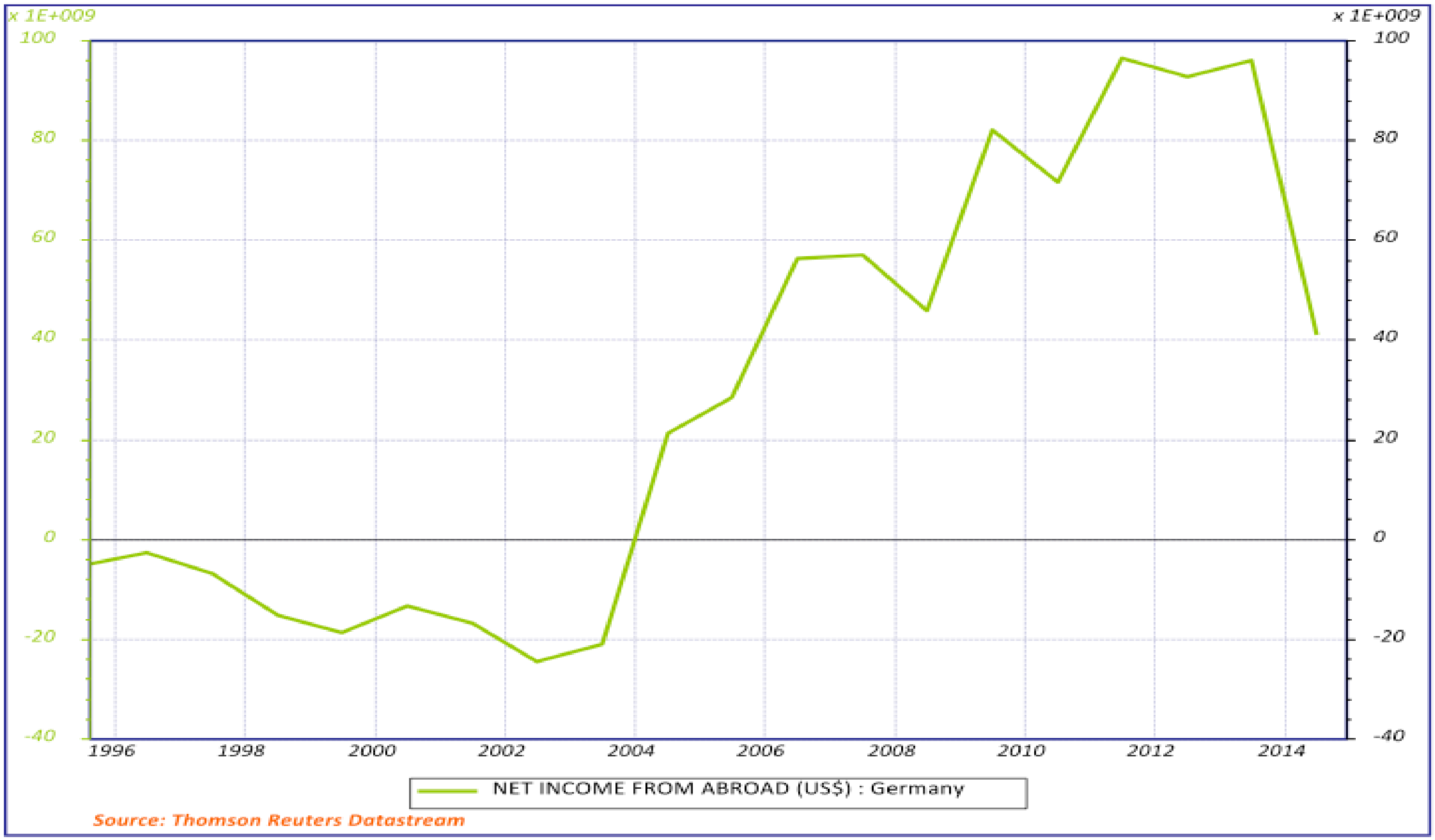
Germany's Imports from the Czech Republic



Germany's Imports from Hungary



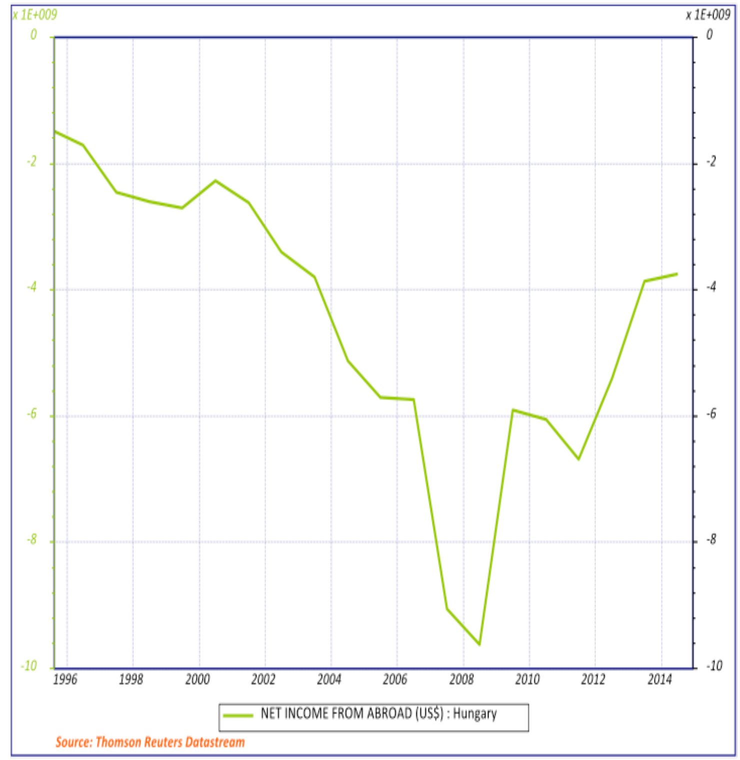
National Net Income from Abroad Positions Reversing? Germany



National Net Income from Abroad Positions Reversing? Czech Republic and Hungary

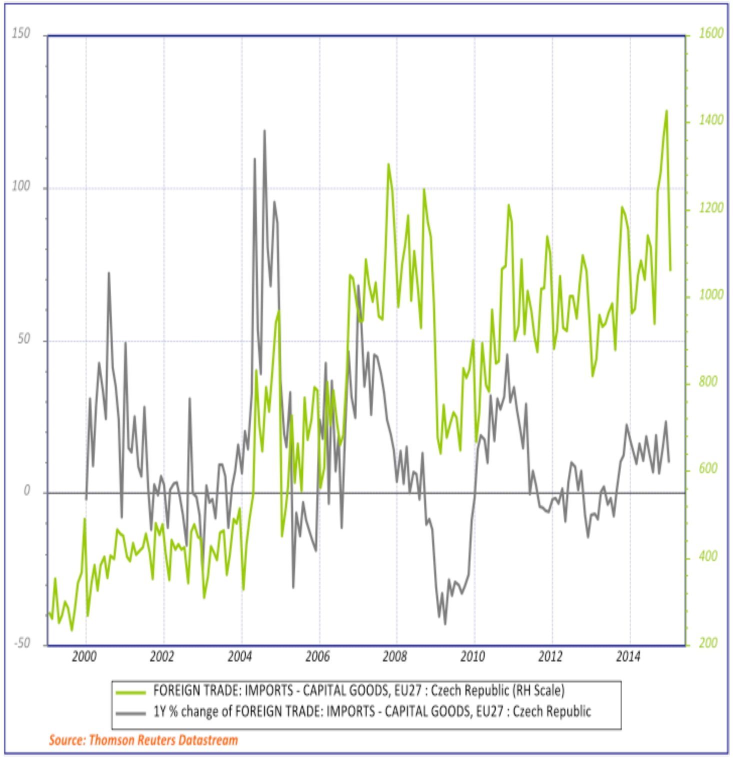
Czech Republic

Hungary

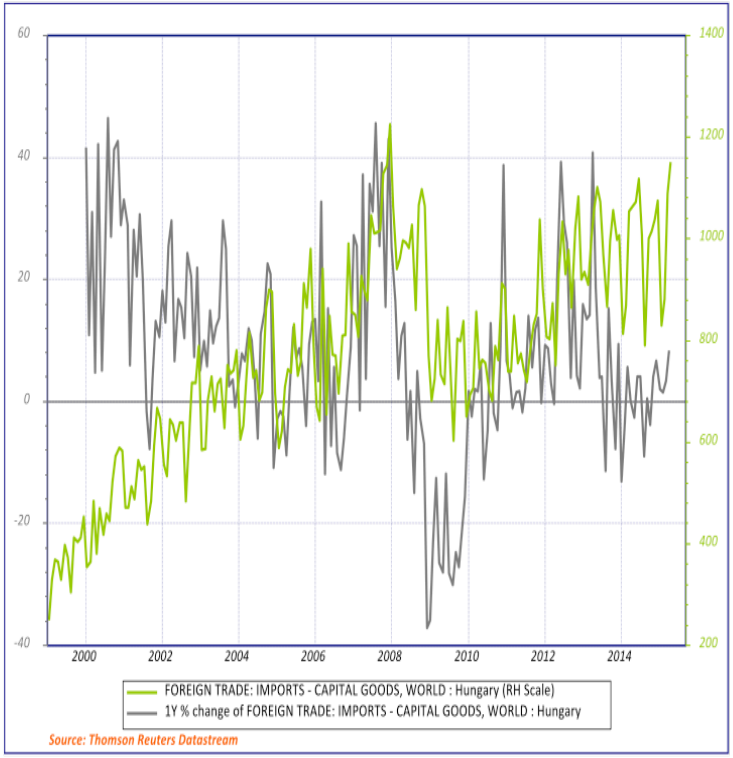


Which suggests that the rebuilding of the Part Suppliers' capital stock has been completed

Czech Republic



Hungary



What do we See here?

- Central Europe used to run chronic deficits, now these countries are all running surpluses

- This is because they were (in part) rebuilding their capital stocks and integrating into the Greater European Export Complex

- **That export complex is now active**

- **Key Question**: *What does this mean for recovery of the region as a whole?*

Problem: Export led Recoveries in a currency union Have Asymmetric Costs and Benefits

- One part of the EZ (Germany and Central European part suppliers) runs perma-surpluses, and are external demand dependent economies with (mainly) low tax and transfer regimes

- The other part (France, Italy, especially) are large domestic demand driven economies with high taxes and transfers that don’t rely on exports and can’t do this without massive internal price adjustments

Why Export led Recoveries Have Asymmetric costs

So what happens when you put these very different varieties of capitalism in a fiscal compact and common currency that disallows deficits for corresponding surpluses?

- You can’t inflate or devalue to adjust
- You can’t default
- So all you can do is internal devaluation – AKA – *permanent austerity* – to adjust to someone else’s surplus

Four Concerns going Forward

First: Is the EU ‘Asia 1999’ Redux?

If this is structural, its hard to go back to running deficits if your basic economic institutions are geared to run a surplus.

Second: A Recovery for Whom?

What happens when one part of the EZ has to contract to balance the other half’s surpluses? The consequent deflationary effects will destroy their center, especially center left, parties.

Third: Bond Market Effects?

The Fed can raise short-end rates, but if this adds to a global surplus of S > I, long dated Euro maturities may be negative for a long time since they are substitute assets.

Fourth: The Big One: Fragility

Europe developed this model because its export sectors post 2008 were able to ride on other people’s stimulus (US and China). If these countries slow down, fail, or raise rates, what happens to this model?

The Take Home

- Coming up with ‘Policies to Avert Stagnation’ is not the problem
- The problem is that one half of the EZ has a new growth model that is parasitic against the other half
- Add to that a background of structural deflation made worse by these policies, and the political space for good policies that sustain the EZ is narrowing