Annual Economic Report 2015/16
German council of economic experts

Discussion

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Four parts

I. Euro area economic recovery and monetary policy
II. Refugee crisis
III. Germany
IV. Stability in the euro area

I will discuss I, II and IV

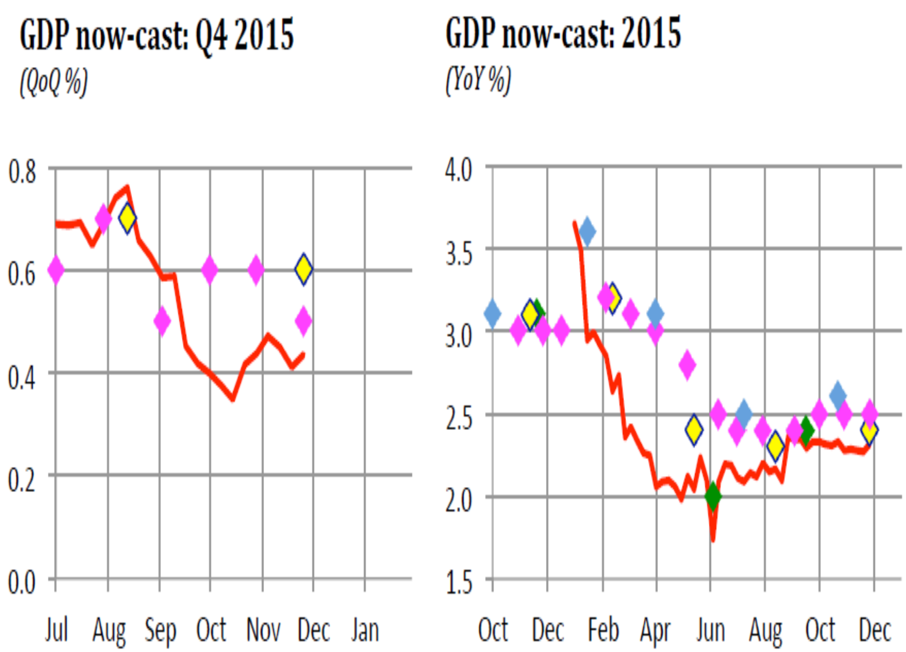
I. Economic Recovery, Expansionary Monetary Policy

1. Recovery under way
2. Fiscal consolidation has come to an end
3. Rebalancing in Germany
4. Monetary policy should normalize … if not, risk of financial stability

I. RECOVERY AND MONETARY POLICY

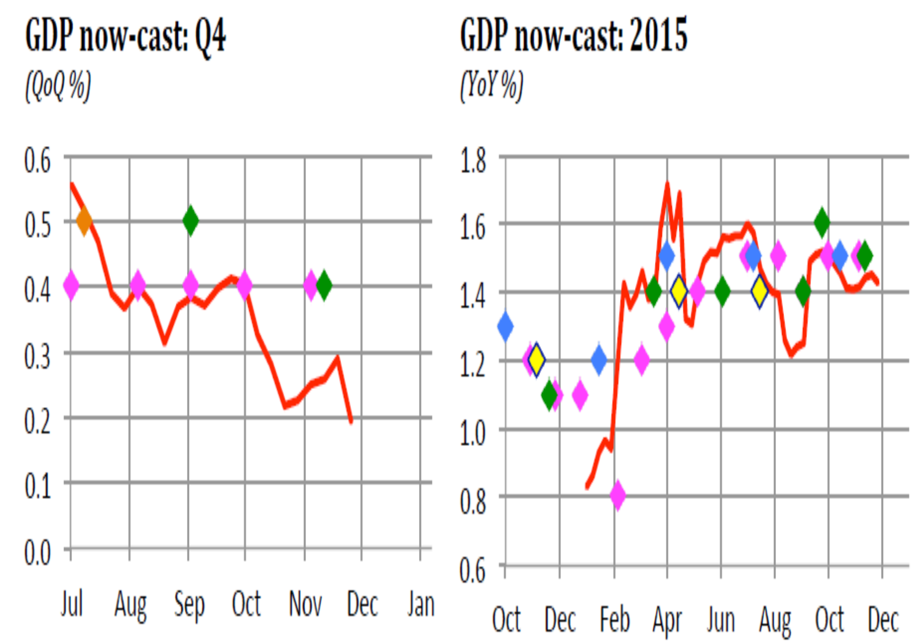
On 1: how strong is the euro area recovery?
The recovery is under way but weak …

The US



Source: Now-Casting Economics

The Euro Area



Source: Now-Casting Economics

Output growth and slack

- 2015 annual growth is estimated at being between 1.4 and 1.6
- Implicit in GCEEs view is that this corresponds potential output growth (output gap is zero) …. Decline in trend growth with respect to the crisis

This implicit assessment on potential growth is key to evaluate monetary policy stance (see later)

2. Fiscal consolidation has come to an end

- Has it? In Germany but not overall

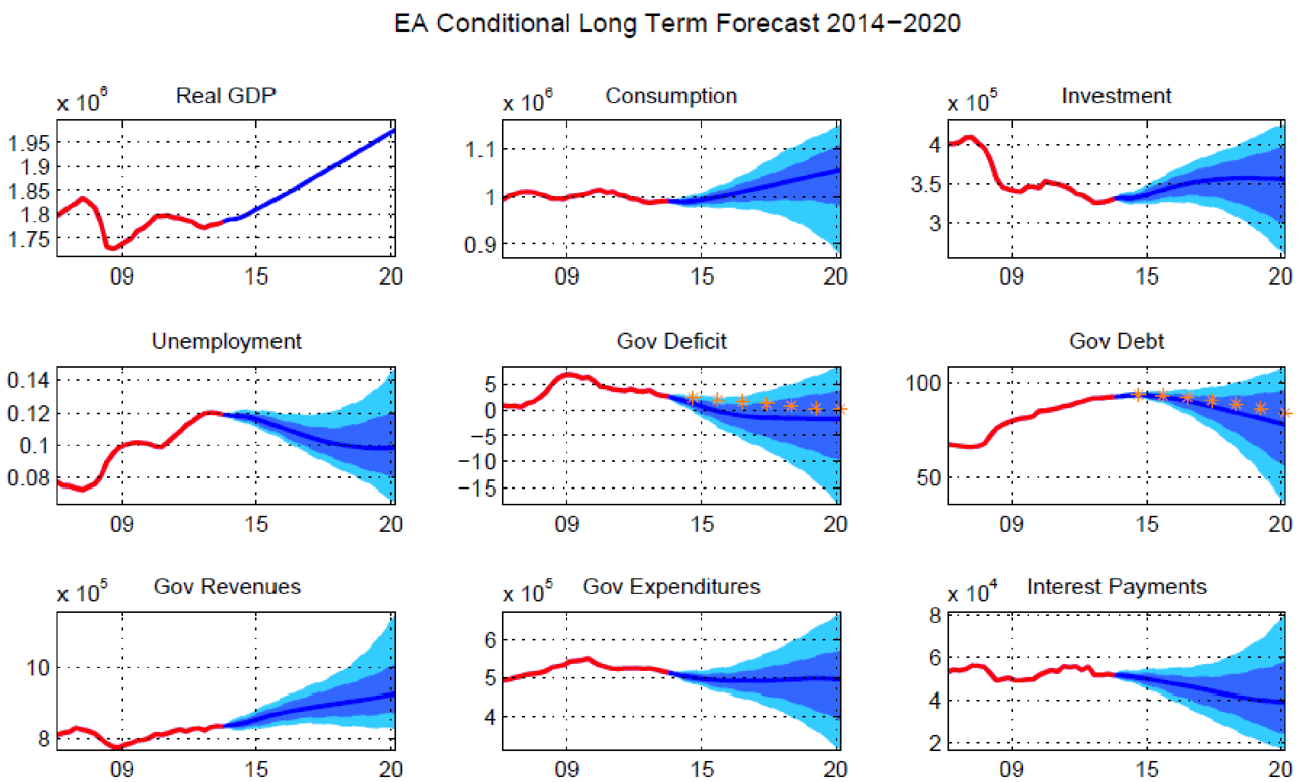
Overall in the EA compliance with debt consolidation path would require more fiscal restraint (see next chart) …. Whether this will happen or whether this is desirable is uncertain

Question: can German fiscal expansion alone make sure that the euro area wide fiscal stance neutral rather than restrictive?

10 billions of extra expenditure refugee-related too small for the task

Two optimistic scenarios – both predicting further fiscal consolidation and very little decline in public debt ratio

Meta forecast: 2014-2020: chart (1/2)



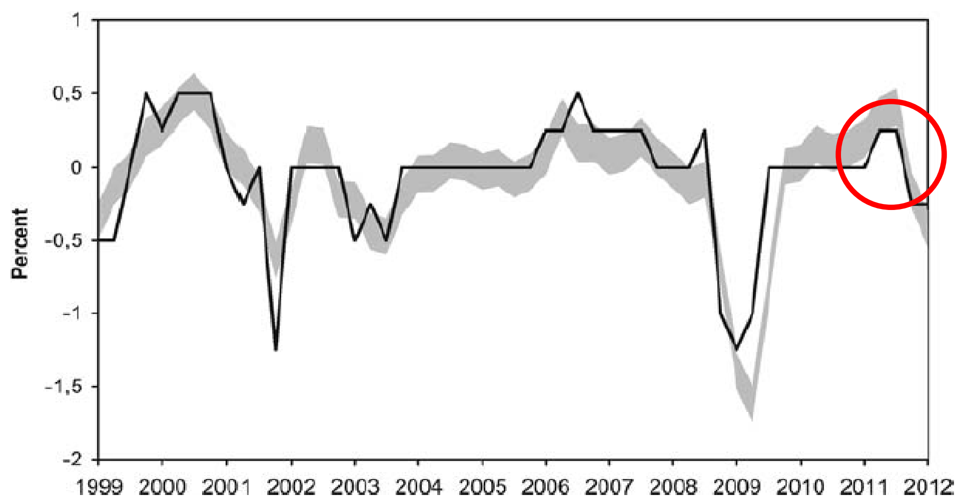
Source: Caruso, Reichlin and Ricco, 2015

4. Monetary policy (i): should the ECB tighten?

GCEE says yes on the basis of Orphanides and Wieland, 2013 Taylor rule

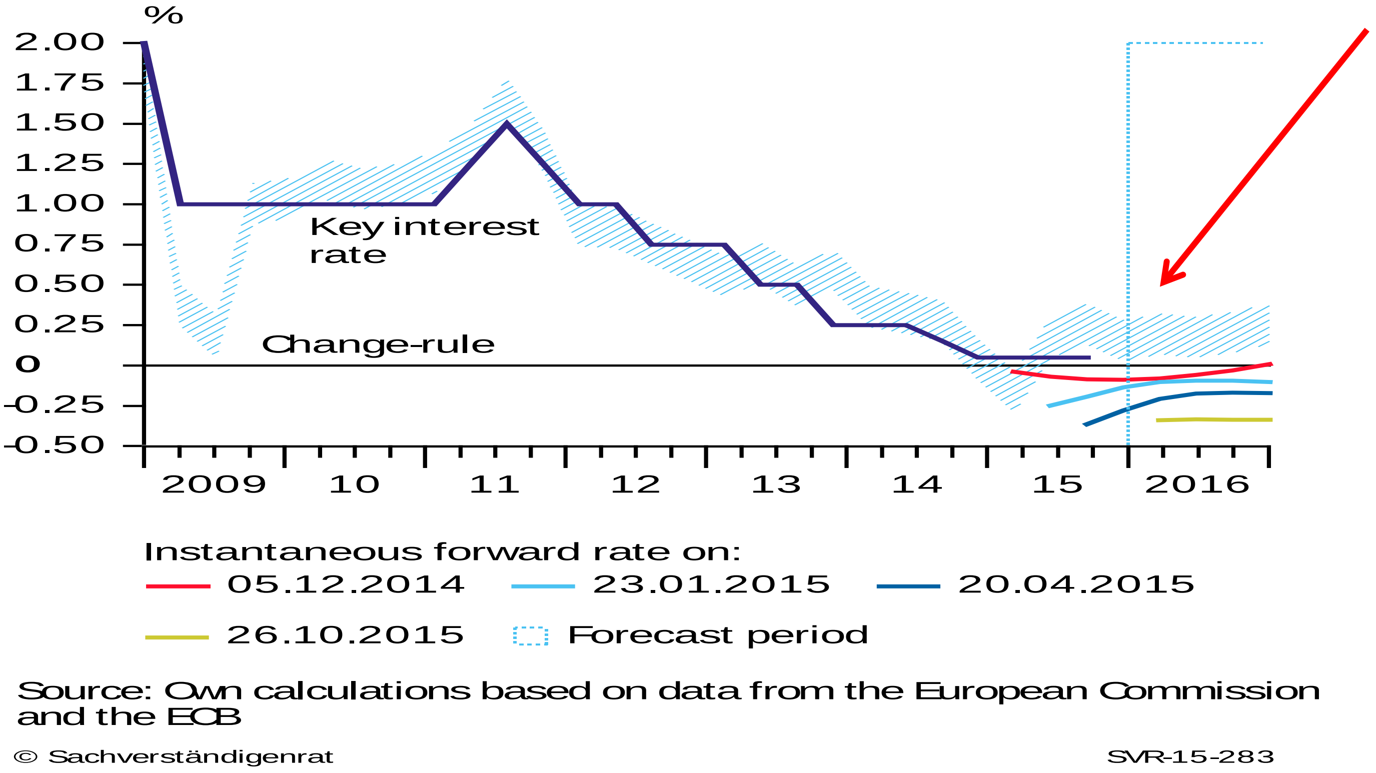
The rule 1999-2012

Figure 6. Policy Rate and Simple Rule Prescription: Quarterly Change



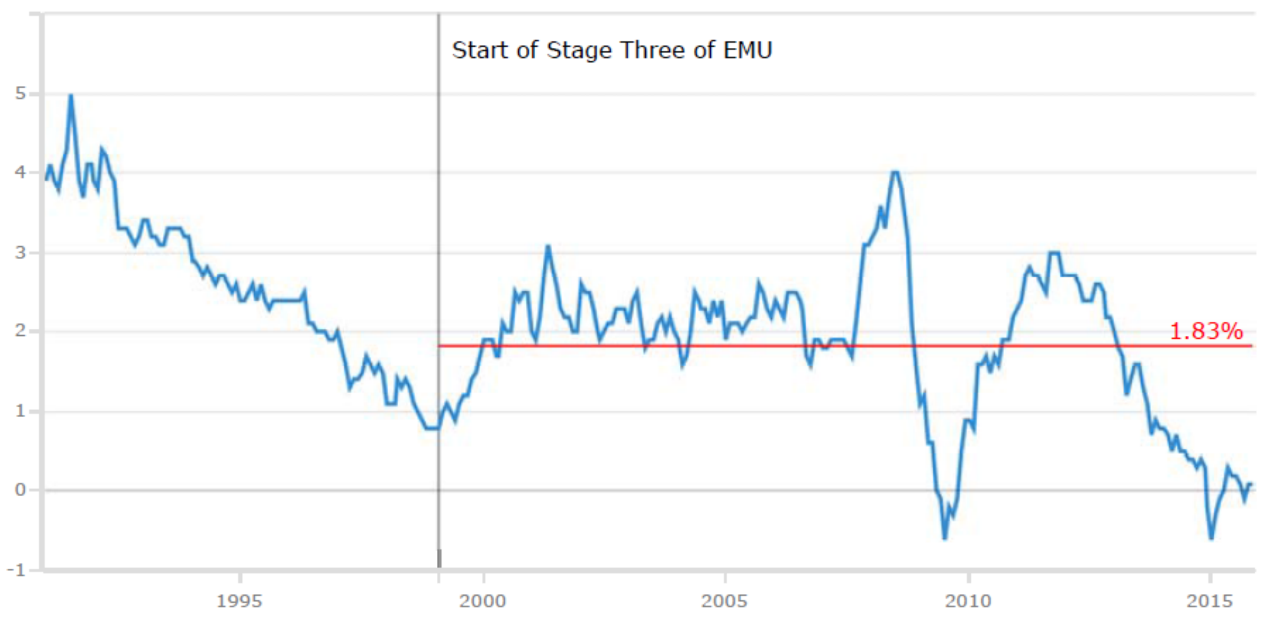
Notes: The shaded area represents the envelope of prescriptions from the simple policy rule, $\Delta i = \frac{1}{2}(\pi - \pi^*) + \frac{1}{2}(\Delta q - \Delta q^*)$. $(\pi - \pi^*)$ reflects the deviations in the SPF one-year-ahead inflation forecasts from either of two bounds as shown in figure 4. $(\Delta q - \Delta q^*)$ reflects the deviations in the SPF one-year-ahead GDP growth forecasts from the potential output growth shown in figure 5. The solid line shows the quarterly change in the ECB policy rate (MRO) following the policy meeting of the second month in each quarter.

How to interpret the rule today?



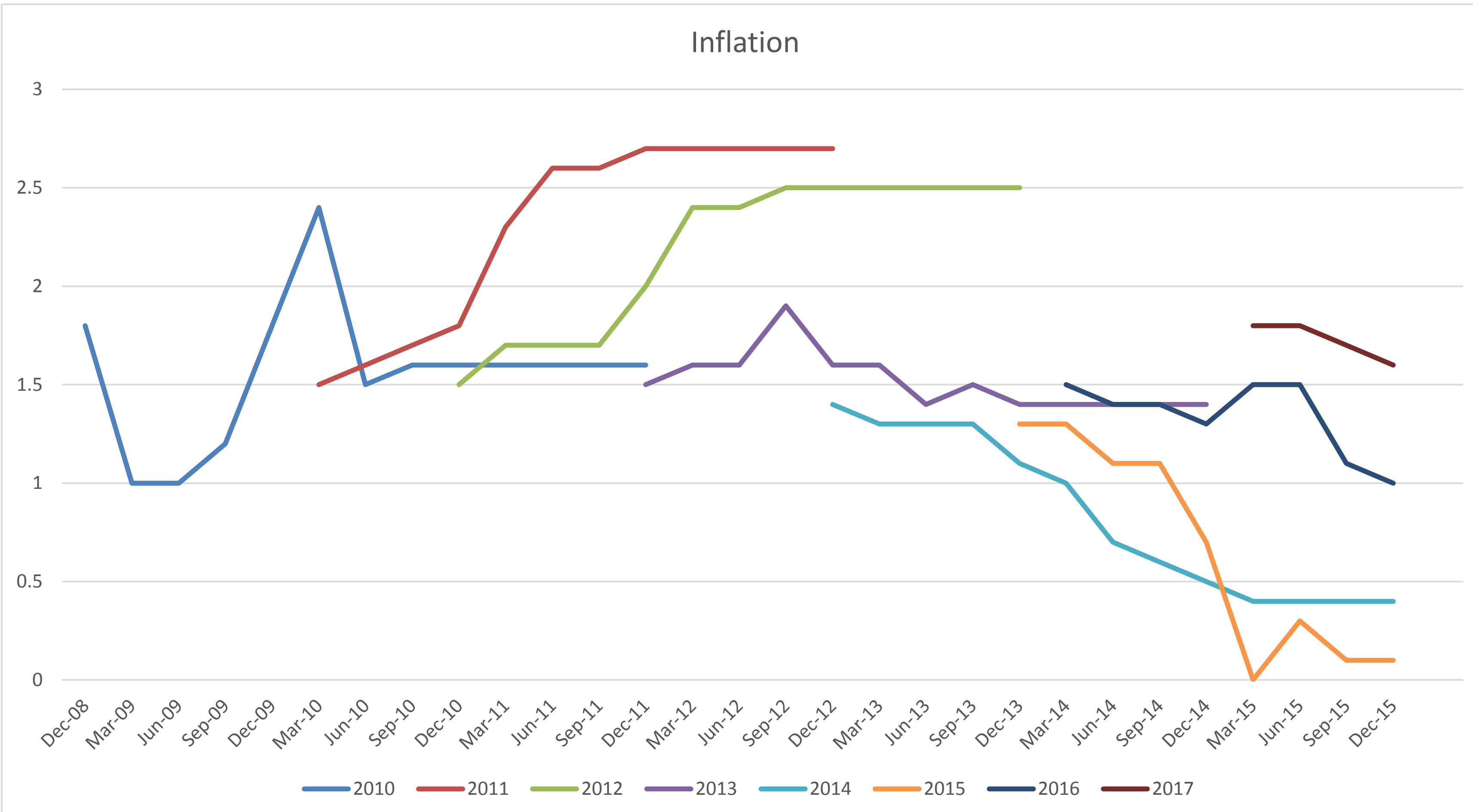
However: inflation

Inflation in the euro area (annual percentage changes, non-seasonally adjusted)

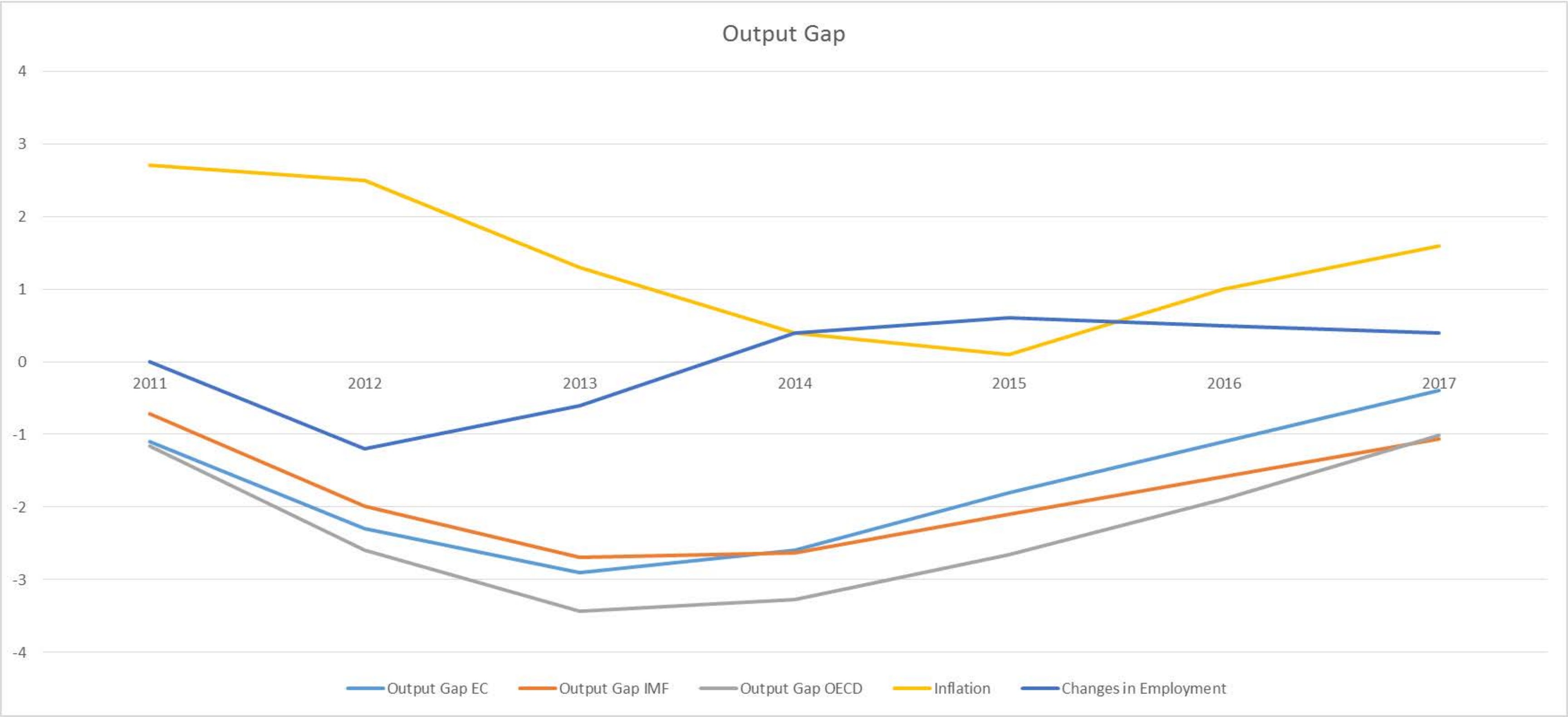


Source: Eurostat. Data prior to 1996 are estimated on the basis of non-harmonised national Consumer Price Indices (CPIs). Average inflation since 1999.

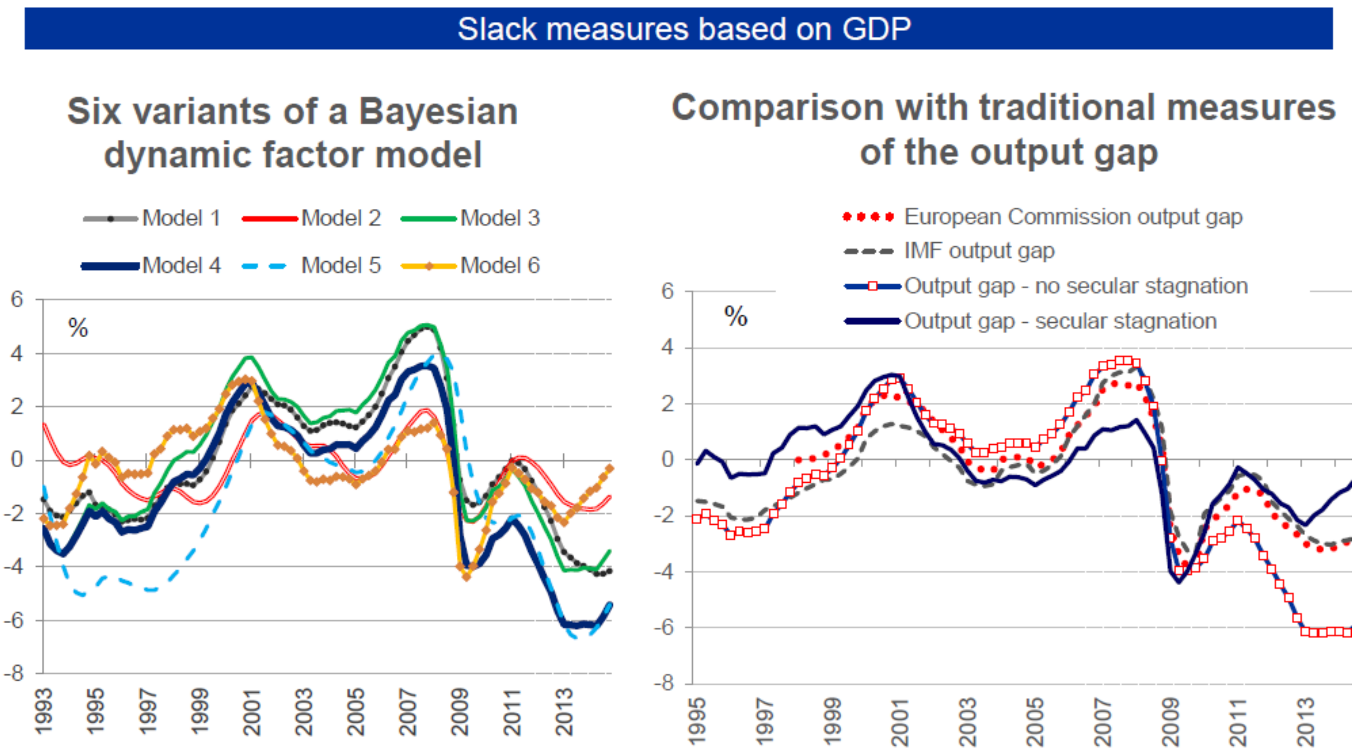
… and ECB forecasts revised downward each year



Output gap: no institution judges it will be closed before 2017



True … measures of output gap vary significantly but: (i) only under the secular stagnation hypothesis it can be judged to be closed; (ii) that model is not a good forecaster of inflation



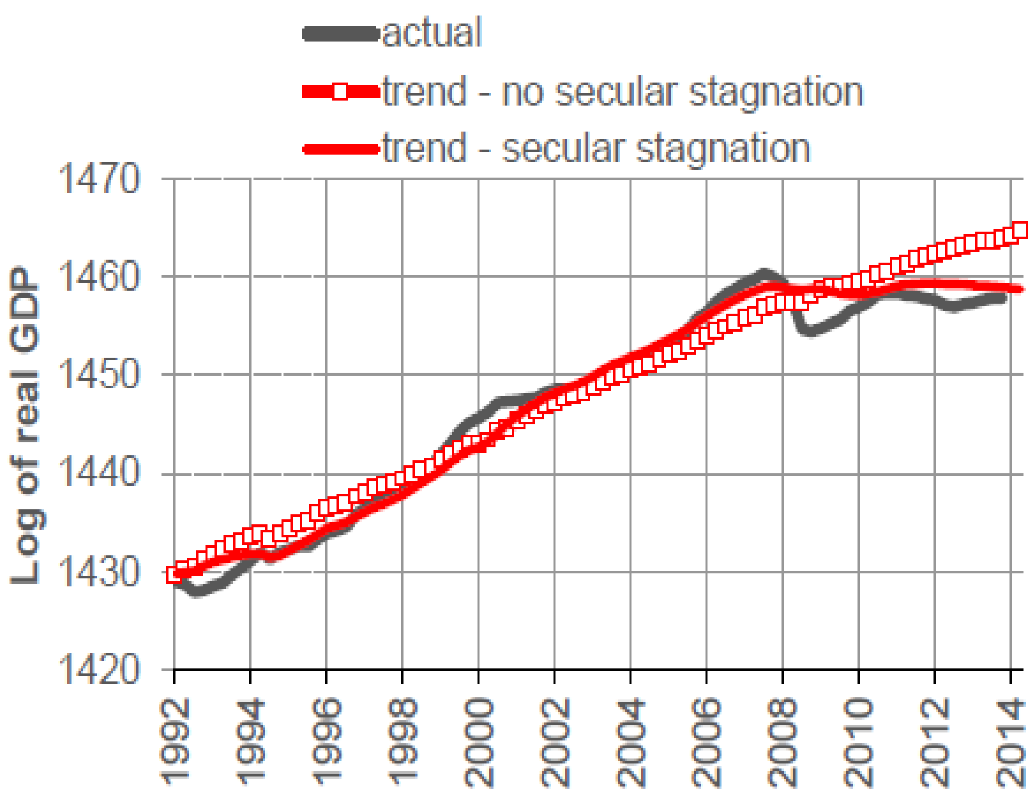
Source: IMF WEO, AMECO, Eurostat, ECB staff calculation

Notes: 2 measures of slack: Output gap - no secular stagnation and Output gap - secular stagnation are derived in "Inflation forecasts in a Bayesian dynamic factor model of the euro area", M. Jarocinski and M. Lenza, 2015, mimeo;

- *Assumption 1: no secular stagnation → continuing trend growth, large output gap. Good inflation forecasts.*
- *Assumption 2: secular stagnation → slow trend growth, closing output gap. Less good at forecasting inflation.*

The IMF and European Commission output gap measures are interpolated.

Secular stagnation? Perhaps but not in the forecast – more plausible is the hypothesis of a slow recovery due to debt overhang



4. Monetary policy (ii): does the “not tightening” stance threat financial stability?

Banks and insurance companies lose under low interest rate … true: P&L pressure

However:

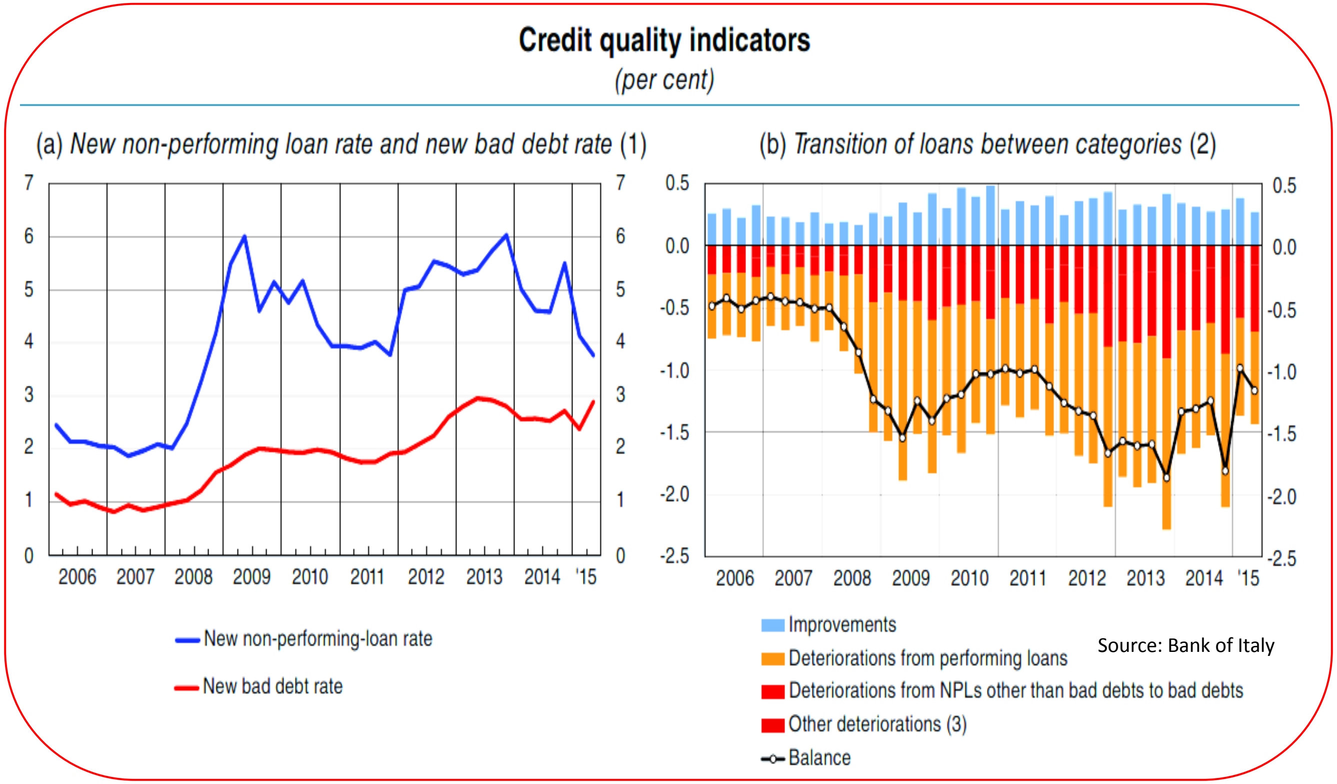
(i) main driver of banks profitability is the real cycle;

(ii) NPLs is the major threats to financial stability in Southern Europe, not low interest rate …

DATA IN NEXT SLIDES

(iii) For what concerns other financial risks – and in particular maturity mismatch in banks’ b/s – QE might reinforce financial stability rather than impair it … Must distinguish between interest rate policy and other monetary policy tools in the central bank toolkit

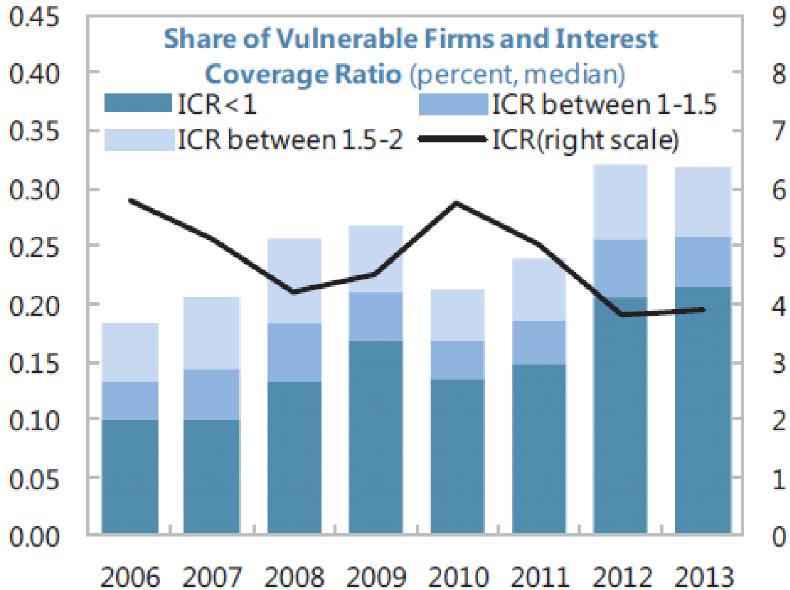
Growth in non-performing loans is gradually slowing but it remains very high as a legacy of the recession (italian data)



- The deterioration in credit quality eased substantially over the last twelve months: in 2Q15 the flow of new non-performing loans as a share of total loans was back to pre-sovereign debt crisis levels. This is definitely an encouraging signal for the Italian banking sector (chart a). Note that the increase in the flow of new bad debt is mainly due to reclassification of loans that were already non-performing (chart b). The Bank of Italy reports that, according to preliminary indications, the flow of new bad debt declined in 3Q15.
- The stock of non-performing loans remains high: at the end of June 2015, total non performing loans were equal to 18% of outstanding loans, slightly up from 17,8% in December 2014. The stock of bad debts amounted to 10,3%. The persistently high stock of bad/non-performing loans is the legacy of the long recession.

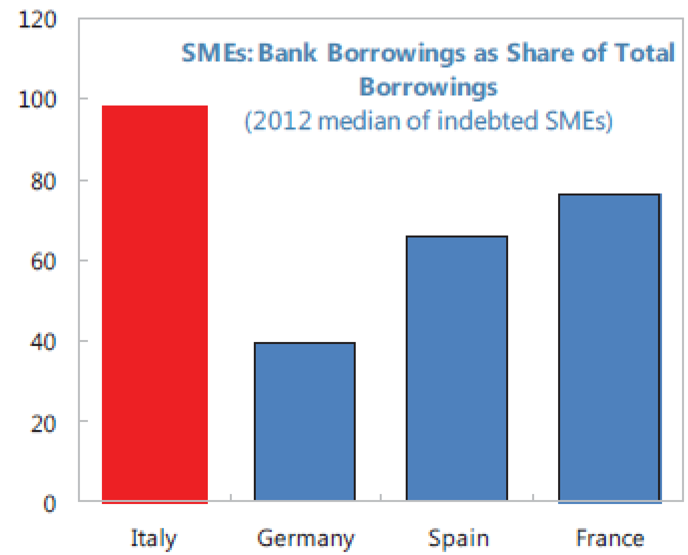
Many firms are vulnerable to interest rate increase

Italy: share of vulnerable firms and interest coverage raio



Source: Orbis, and IMF staff estimates.

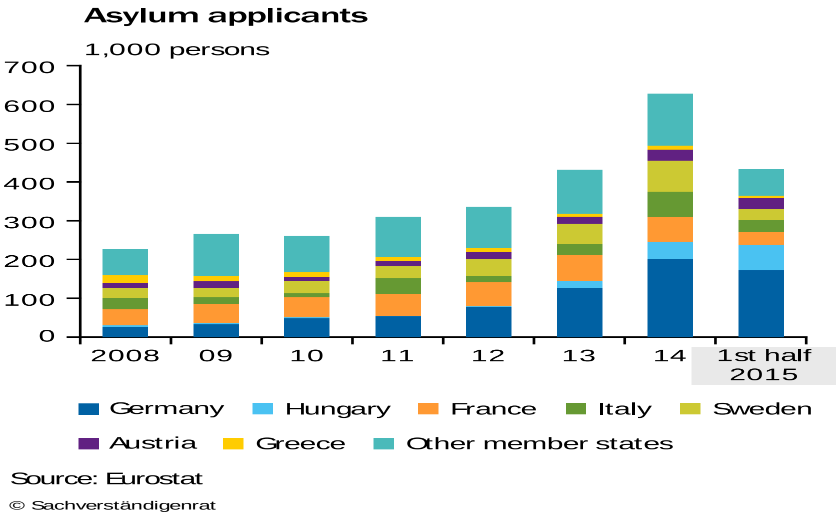
SMEs in the EA depend on banks' credit

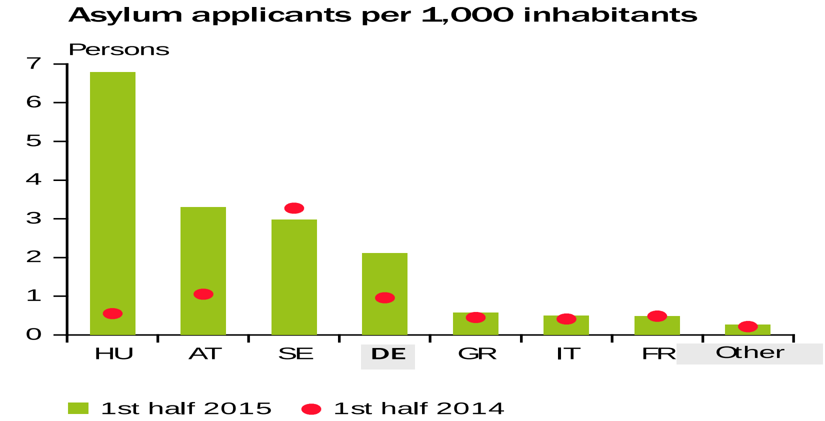


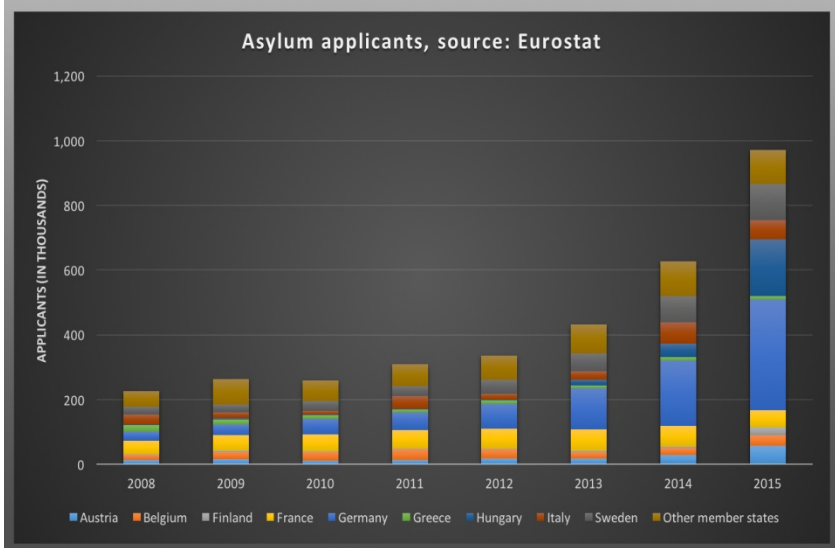
Sources: BACH database and CERVED.

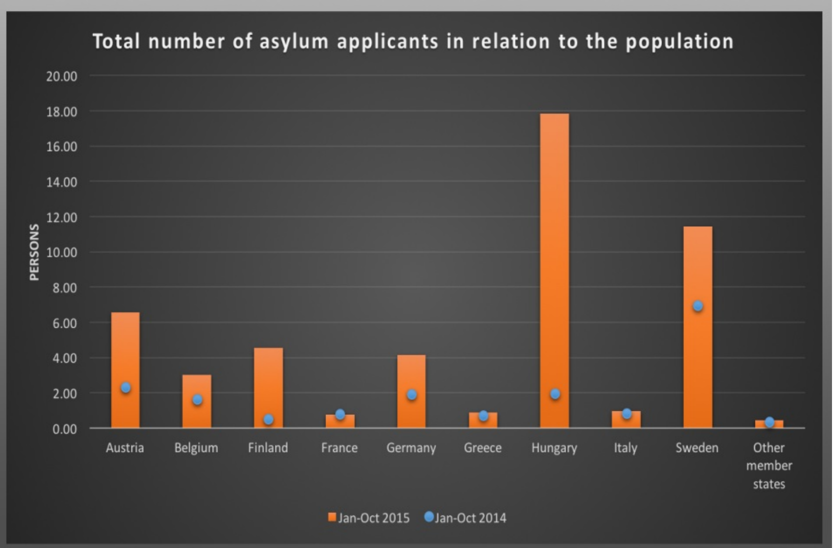
II. RESPONDING TO THE REFUGEE INFLUX

Data 2014 1nd 2015









Issues

1. Two aspects: (i) security and (ii) integration. Potentially big numbers (compare Frontex budget with US case)
2. A EU problem (big numbers in Sweden and Hungary) … which needs a EU solution

…. Need spending capacity at the EU level

3. Implications for the euro area: where is the fiscal space?

Two options:

(i) accept further flexibility in fiscal rules …. Dangerous!

(ii) Increase joint spending capacity at the EA level – possibly a special vehicle jointly guaranteed …. Preferred!

III. PATH TO MORE STABILITY IN THE EURO AREA

III. Paths to More Stability in The Euro Area the GCEE view

- **The Goal: a more robust fiscal and financial framework.**
- Fiscal: create disincentives to over-borrow (public or private), credible regime that limits official lending and involves the private sector. *(New Lending Regime)*
- Financial: delink national banks and sovereigns, pricing sovereign risk, *(New financial regime)*
- How to get there: Need to reduce excess debt rapidly and equitably *(Eliminate Legacy)*

The constraints : little appetite for more Europe (no mutualization)

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the ECEE view

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(i) Debt/solvency framework

Steady state versus transition

Steady state: okay to reinforce the debt/solvency framework. Like the principle (see ECEE CEPR report)

But how do we get there? Need to deal with the debt overhang problem first (the transition)

Empirical issue: how much of a problem is the debt overhang problem?

1. it limits spending capacity and drags on demand
2. it threats financial stability
3. it implies burdening the ECB with too much responsibility in terms of stabilization policies

We think is a BIG problem!

(ii) Sovereign exposure

- The GCEE proposes risk-adjusted large exposure limits and capital requirements for sovereign exposures

Alternative proposal by the ECEE:

link the solution of the bank-sovereign loop problem with the creation of a safe asset which:

(i) will serve to limit bank‘s exposure to own sovereign;

(ii) can help the creation of a safe asset which does not require mutualization and that can be targeted by ECB sovereign purchases

ECEE proposal

The asset: a safe asset as a bond formed by the senior tranch of a set of national bonds in fixed proportion

- Fixed proportions equal to GDP shares of country (to avoid politics)
- Two tranches
  - A senior bond, 60% of total collateral
  - A junior bond, absorbing the first default
- Inspired by ESBies but market based (no Debt Agency/new institutions)

How to do it?

1. Change regulation

- Only the senior tranche of the security so produced could be counted as risk-free for the purposes of the risk weighting and liquidity coverage ratio calculations

2. Change implementation of QE

- QE should announce that QE purchases would target such synthetic safe bond

The private sector buys debt, warehouses and sells assets

Four advantages of our proposal

1. Deals with Risk on / Risk Off
   - governments CAN default in this world, as the banks are protected from the fallout
   - Market discipline: markets will thus monitor the governments instead of second guessing the (bailout) intentions of the ECB
2. Reduces substantially the geographic bias in the flight to safety
   - Safe asset would be (regulatory) a Europe-wide one
   - Reduces the chance that a problem in sovereign bonds will feed back through local banks to governments

Four advantages of our proposal

3. Eliminates a crucial factor that determines country risk
   - Bank portfolios diversified
   - Holdings of a true safe asset. Creates a large safe asset potentially to be targeted by QE

4. No moral hazard /no hidden redistribution
   - Does not involve any risk sharing among different governments nor any debt mutualization : each government would continue to issue its own debt and face its own interest rates in the market
   - Limits cross-subsidization North to South