BRUSSELS ECONOMIC FORUM 2007
Global Adjustment and EMU
Thursday, May 31st

Inter-country adjustment, fiscal policy and the real exchange rate

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The context

- Subdued aggregate performance
- Persistent divergences between countries – Germany versus Spain
- Recent study: *European Economy 6.* Interest rate and competitiveness channels

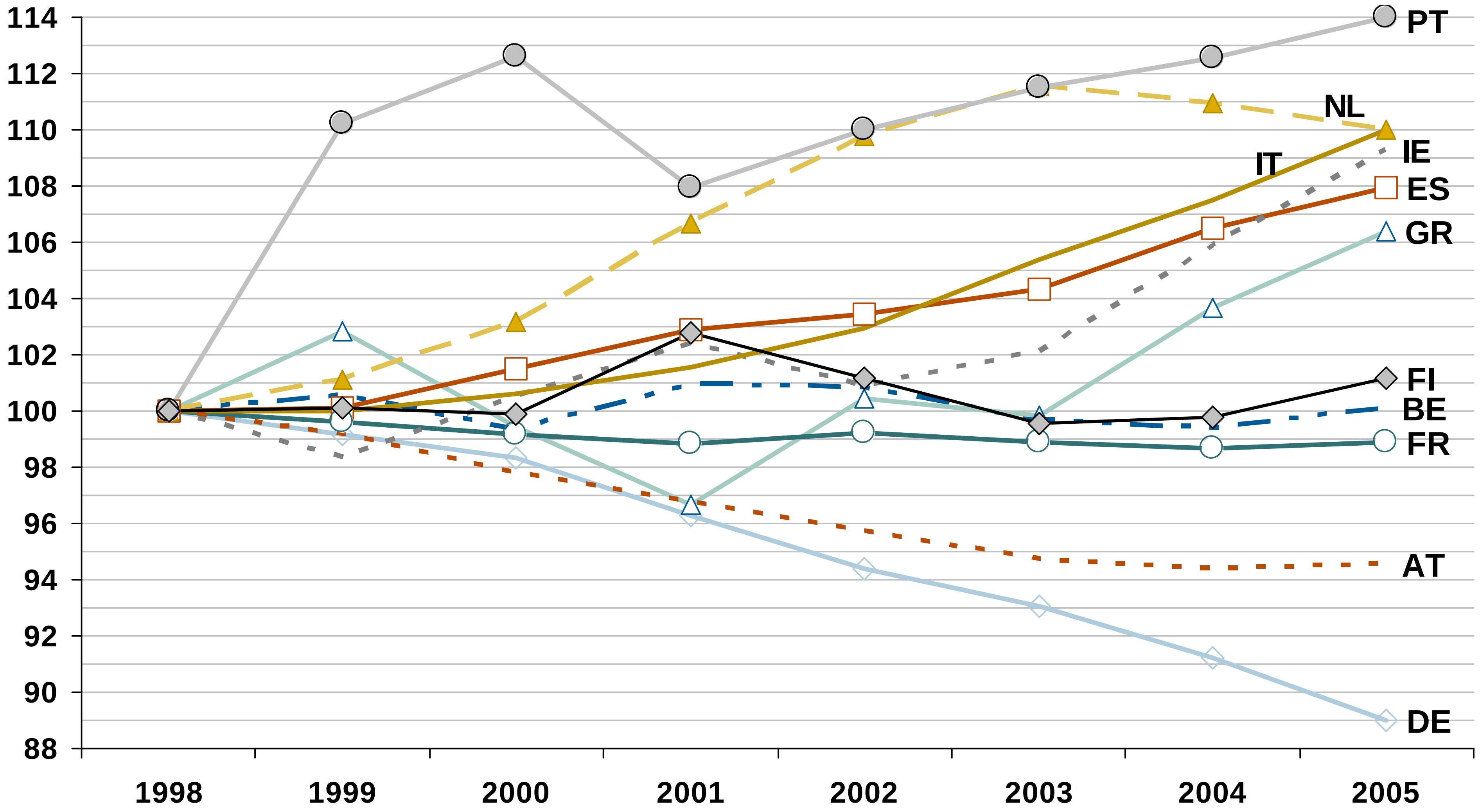
The macroeconomic framework in aggregate

- The Maastricht assignment
- Monetary policy oriented system (The NCA)
- Subsidiary role of fiscal policy
  - SGP – more than assures sustainability
- Fiscal policy 'internalised' by M-policy. Fiscal policy does not matter very much (for stabilisation and inflation)

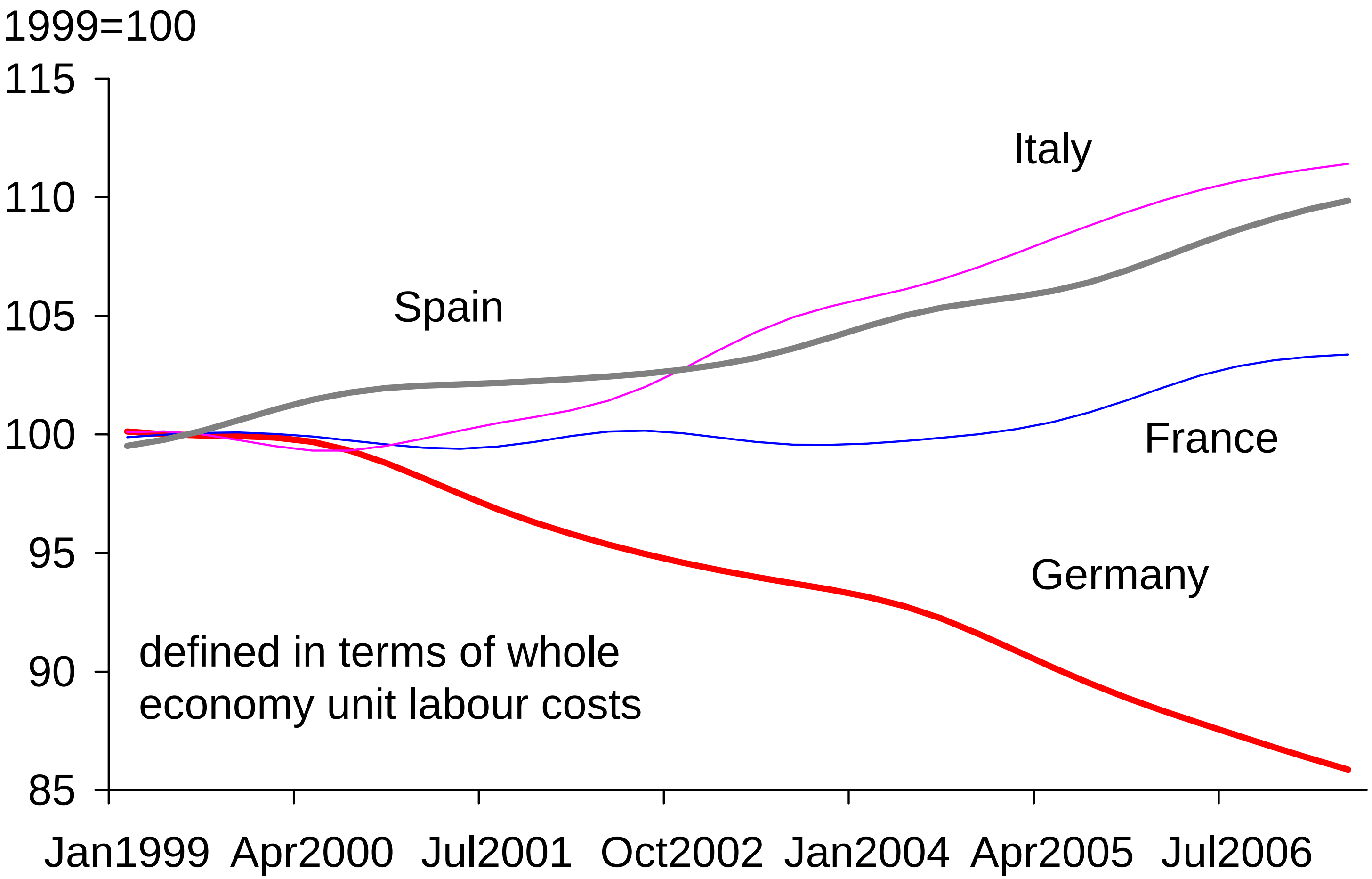
The consensus view (EMU After 5 years)

- Broadly appropriate ECB reaction function
- Fiscal policy failures at country level in meeting the provisions of the SGP (especially Germany).
- But fiscal policy not to blame for poor performance.
- Therefore – it must be the 'supply side'.

Real effective exchange rates



Eurozone: Real exchange rate vs rest of region



Source: EU Commission

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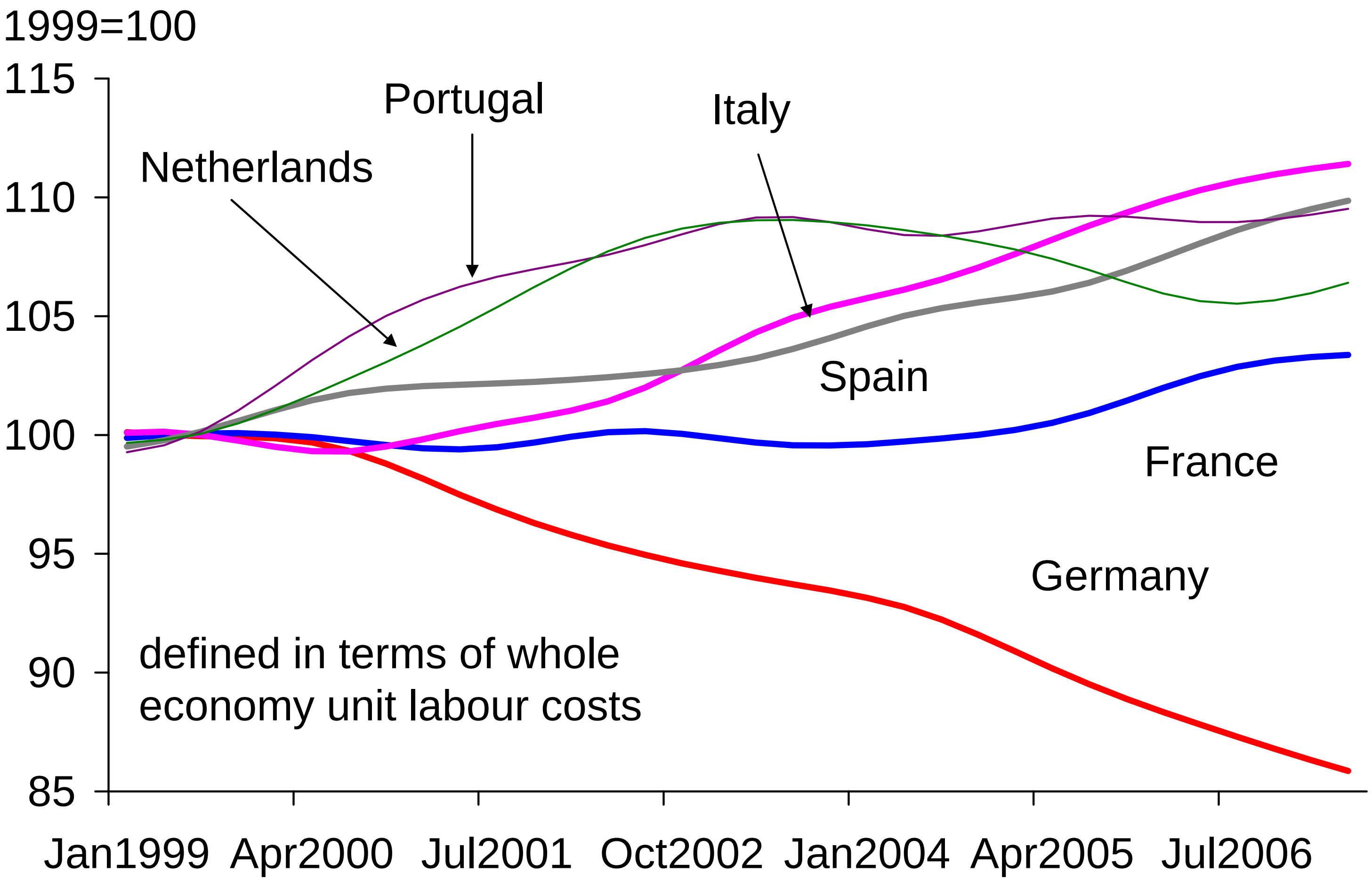
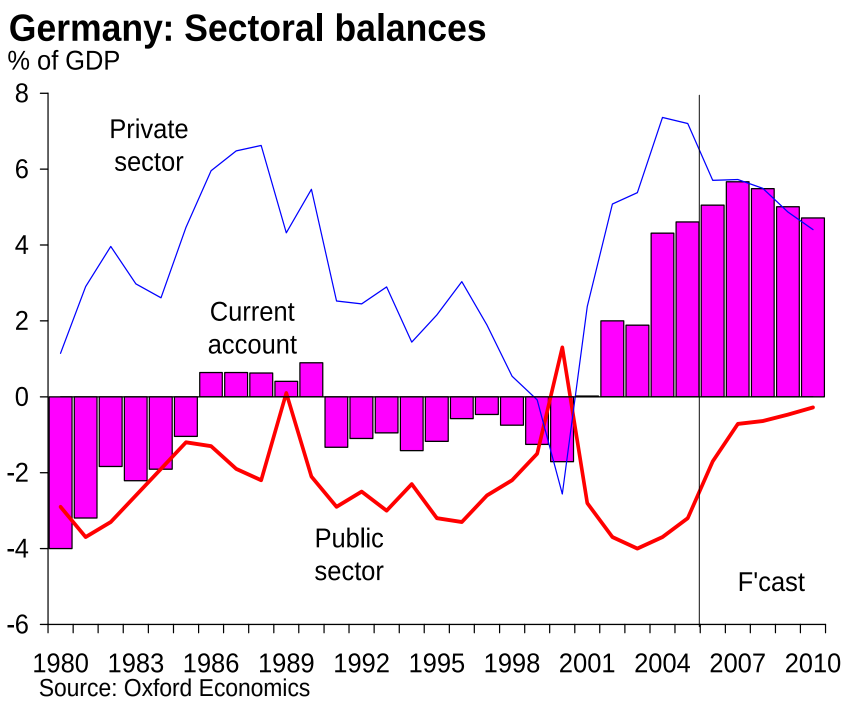
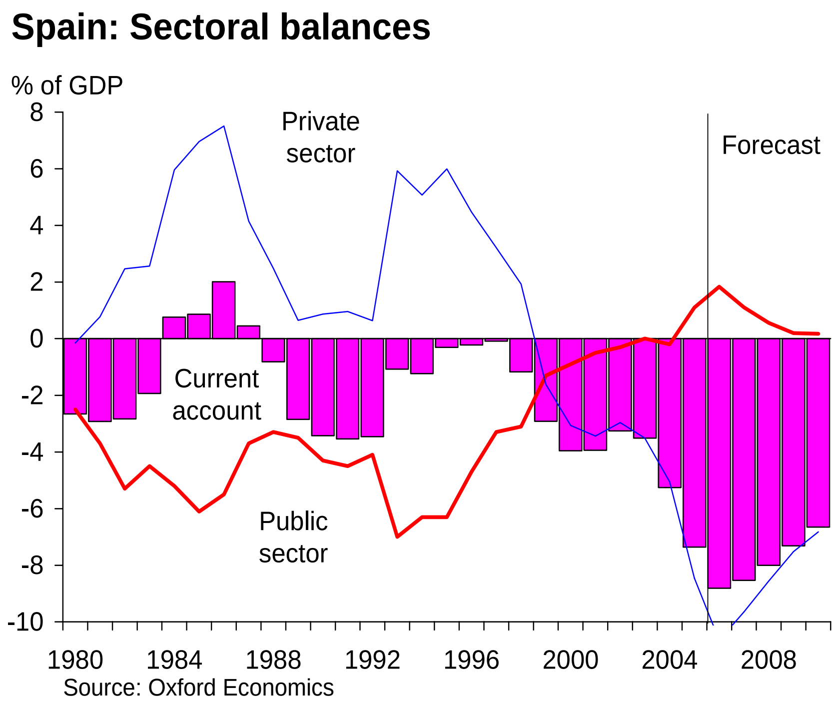


Source: EU Commission

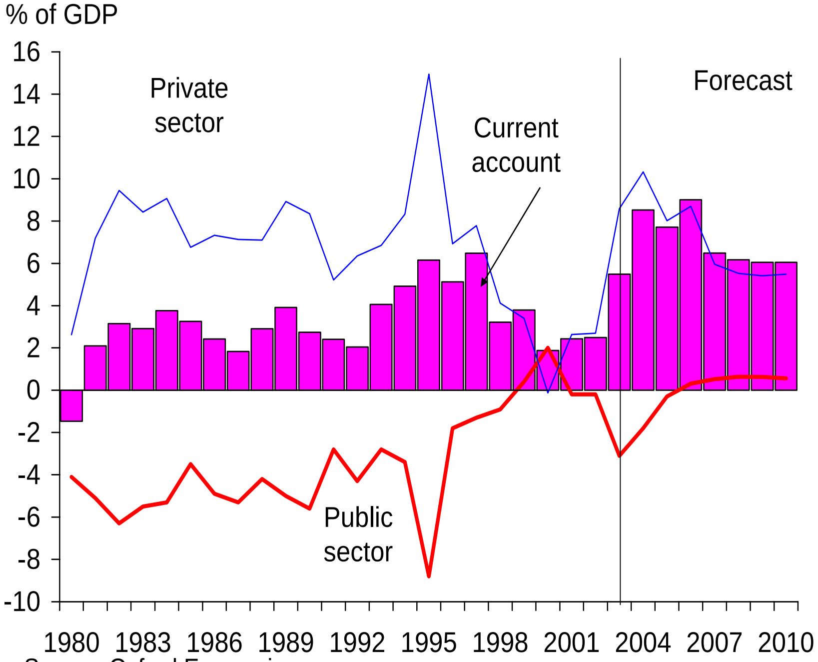


Germany: Sectoral balances
% of GDP
8
6
4
2
0
-2
-4
-6
Private sector
Current account
Public sector
F'cast
1980 1983 1986 1989 1992 1995 1998 2001 2004 2007 2010
Source: Oxford Economics



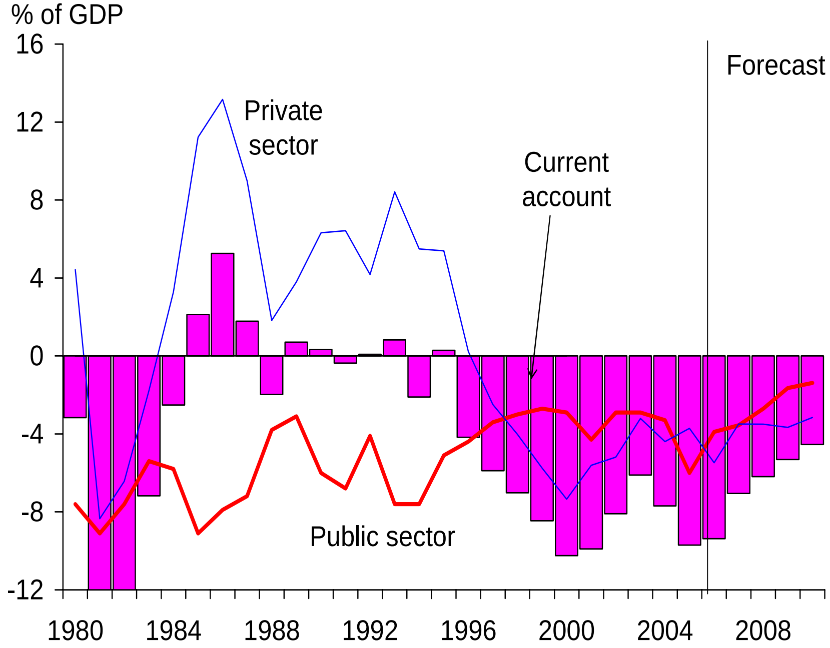
Spain: Sectoral balances
% of GDP
8
6
4
2
0
-2
-4
-6
-8
-10
Private sector
Forecast
Current account
Public sector
1980 1984 1988 1992 1996 2000 2004 2008
Source: Oxford Economics

Netherlands: Sectoral balances



Source: Oxford Economics

Portugal: Sectoral balances



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Fiscal framework much more important at country level and for intercountry adjustment.

For an individual country, the nominal exchange rate and nominal interest rates are fixed. Fiscal policy is the main stabilisation instrument.

Conventional view: fiscal policy (including automatic stabilisers) useful for dealing with asymmetric, country specific shocks.

Fiscal policy reaction functions? (HM Treasury 2003, Swedish Govermment 2002). The monetary policy analogy and ‘constrained discretion’.
Fiscal policy committees (Wyplosz 2002).

Difficulties with fiscal policy for a country in EMU

Pragmatic difficulties (automatic stabilisers OK)
Stability
Adjustment (the real exchange rate)
Policy and coordination

Stability

The Walters critique

Real interest rates move perversely

It is the price level (not inflation) that matters

Price level (relative real exchange rate) overshoots have to be reversed

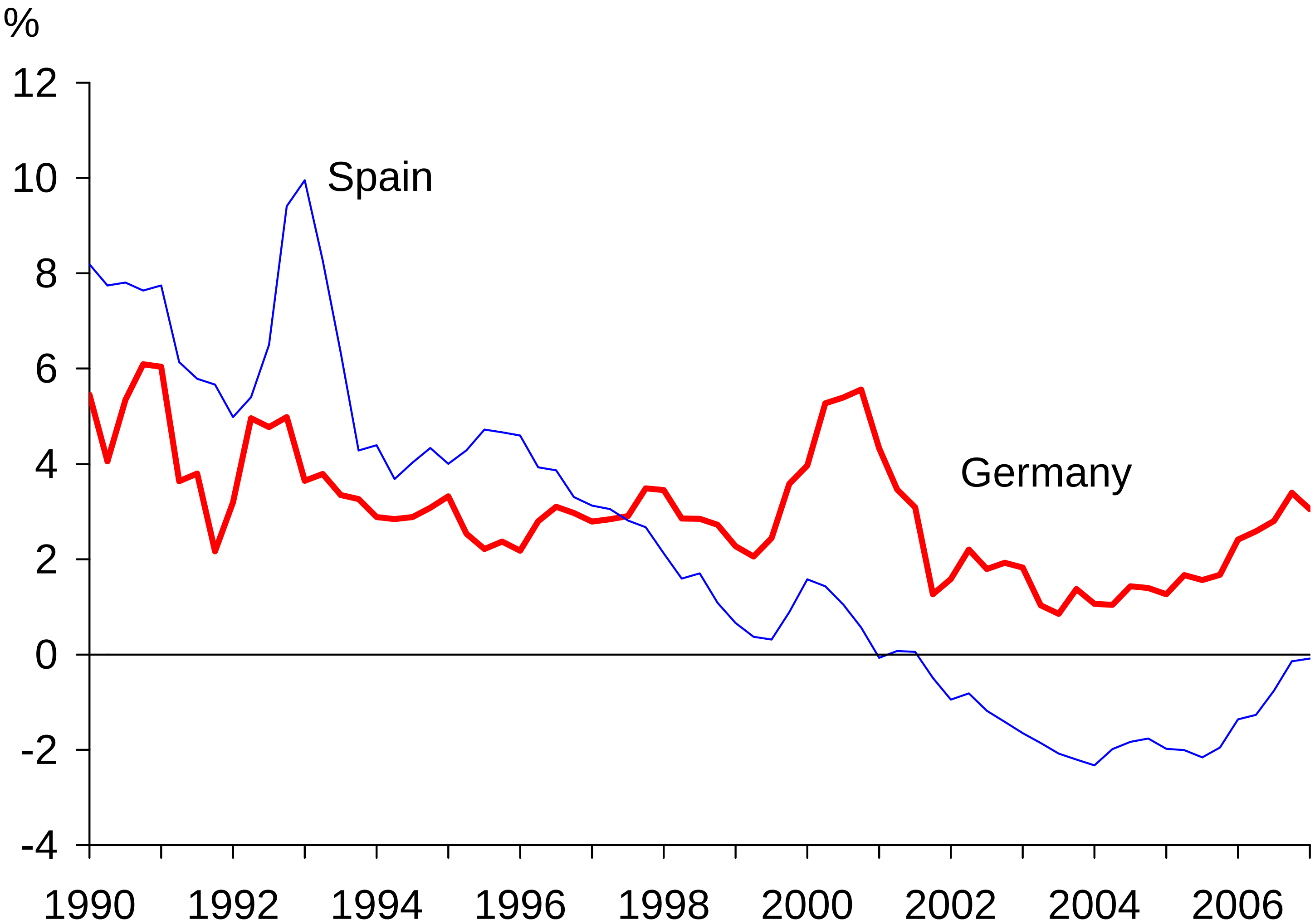
The combination of these two problems means that the design of appropriate fiscal policy is not easy - potential for overshooting and instability.

Both problems are exacerbated by tight debt and deficit targets

Potential solutions

Strong fiscal feedback from inflation to cancel Walters critique
Forward looking behaviour
Centralised wage formation and incomes policies – to avoid inflation shocks and stabilise responses

Real short term interest rates



Source : Oxford Economics/Haver Analytics

Stability

The Walters critique

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Adjustment: persistent shocks

Medium term Macroeconomic balance requires real exchange rate to adjust appropriately

Examples of adverse shocks

- A rise in euro area interest rates
- A fall in domestic competitiveness
- A rise in the domestic savings/investment balance, or a change (reduction) in debt target

Three way nexus between persistent shocks, fiscal sustainability and the real exchange rate.

Ultimately, it is the real exchange rate that must adjust to ensure macroeconomic balance and fiscal sustainability.

The danger of conventional fiscal reaction functions – preventing needed real adjustment.

The opposite danger of rigorous debt and deficit targets forcing recession and price wage adjustment – with danger of overshoot and instability.

Policy and policy coordination

Potential instability possibly apparent in Spain and Germany – interest rates, real estate prices.

Fiscal policy could counteract in Spain. Germany limited by SGP and by need for real exchange rate fall.

Direct targeting of fiscal position risks instability and overshoot

Target an appropriate (forward) real exchange rate, consistent with medium term fiscal objectives, using the fiscal instrument? (Implies tolerant attitude to deficits and debt during adjustment).

Alternative policies: supply side improvements to improve (relative) competitiveness: incomes policies. (Additional instrument removes many difficulties)

Need for inter country coordination – real exchange rates and balance of payments positions

Concluding remarks

In monetary policy oriented systems (euro area in aggregate) fiscal policy does not matter very much for stabilisation and inflation. (The mix does matter for interest rates and the exchange rate). This is in line with the consensus that fiscal policy should be largely concerned with ‘good housekeeping’.

It is dangerous to transplant this consensus to fiscal design within EMU.

Tight fiscal rules, such as the SGP, risk generating instabilities and may exacerbate the adjustment problem between countries.

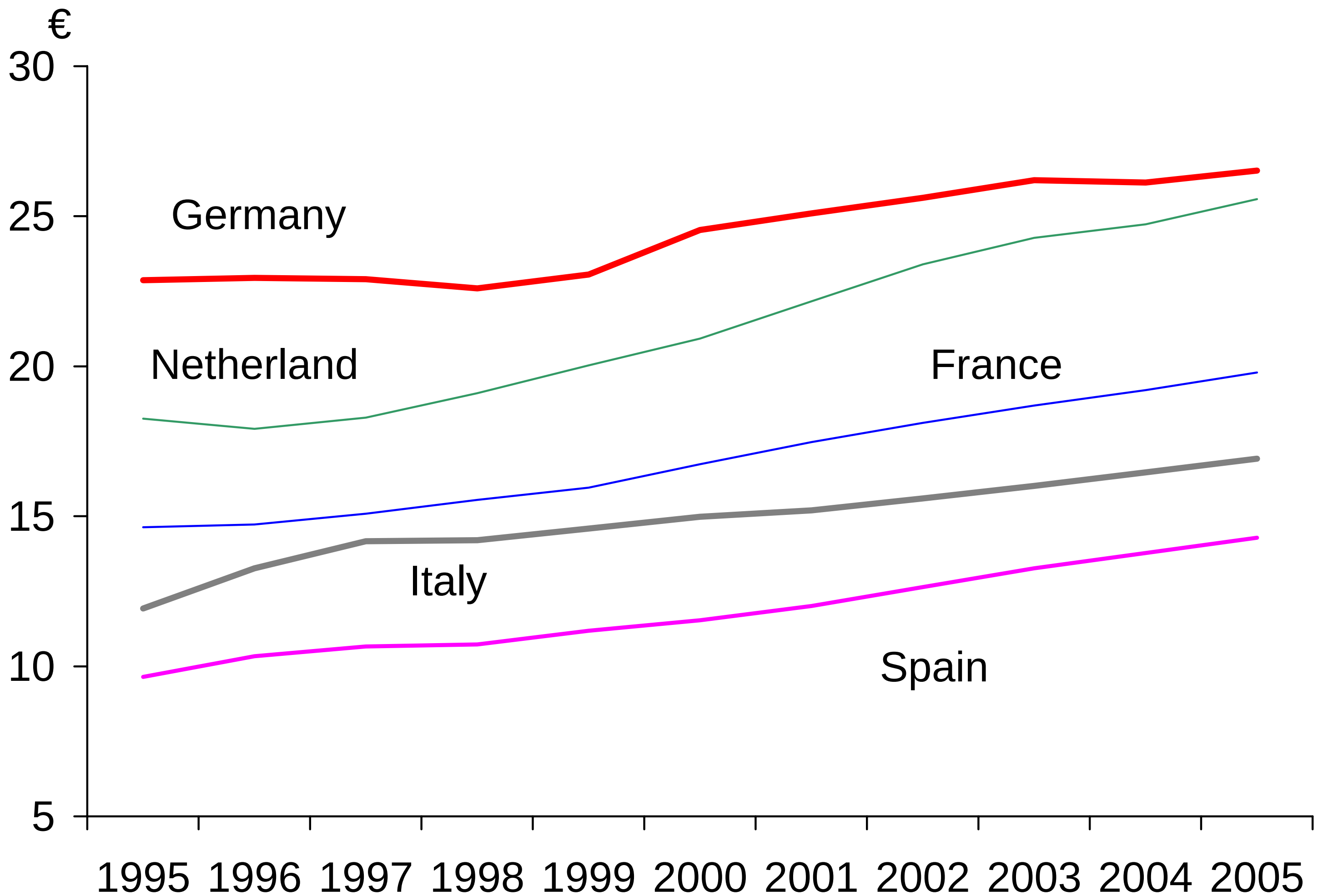
In an immature currency area with separate labour markets, real exchange rate adjustment between countries and regions is likely to be necessary – but potentially difficult.

There is a consensus that medium term fiscal discipline is necessary. Direct focus on the fiscal position (e.g. targeting the fiscal instruments on an objective for the debt ratio) may be less effective than focusing on the real exchange rate required to meet fiscal objectives in the medium term.

Coordination issues arise with any policy to adjust relative real exchange rates.

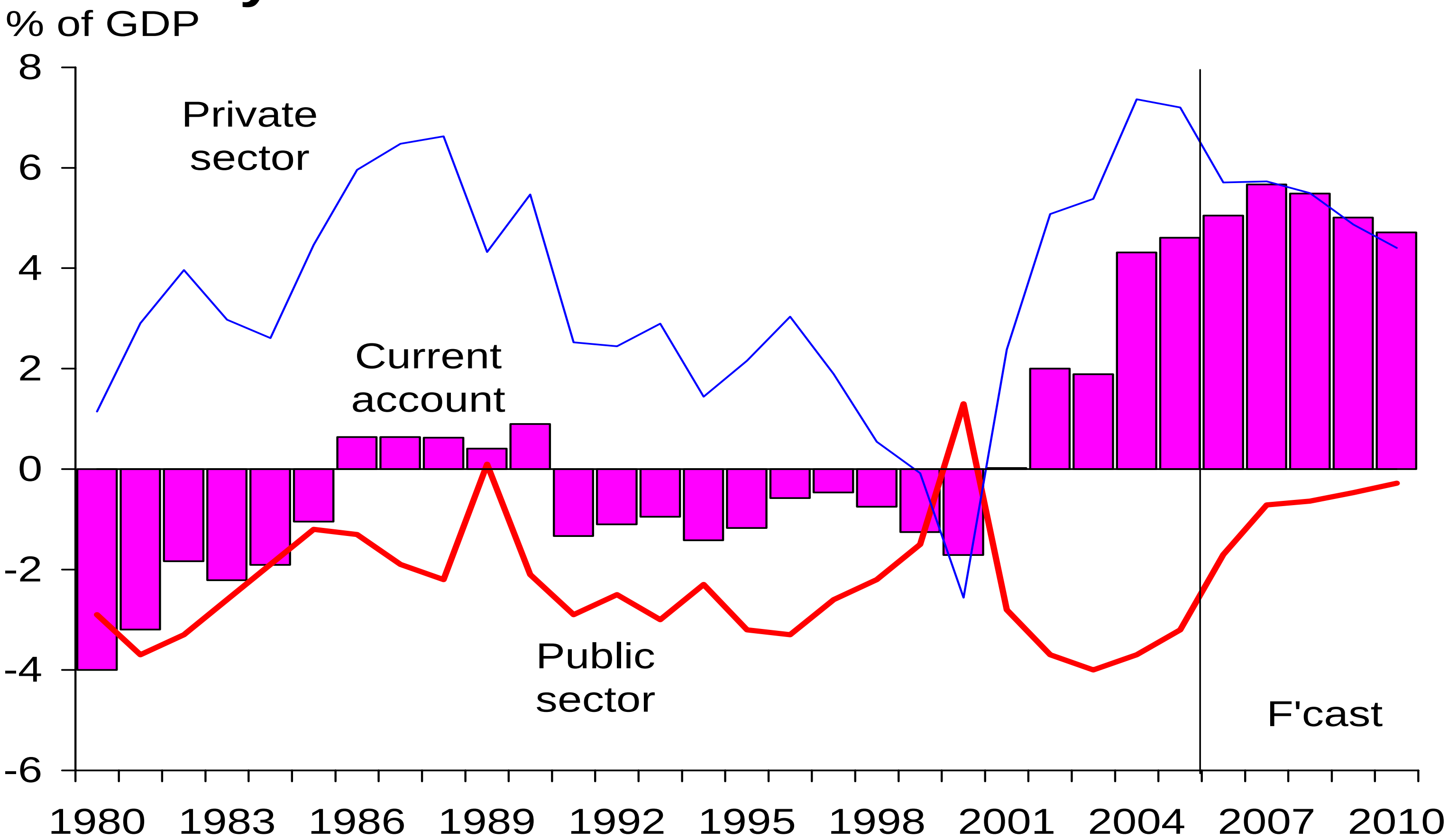
Finally: Are Germany and Spain overshooting – or is this a benign adjustment?

World: Hourly labour costs in manufacturing



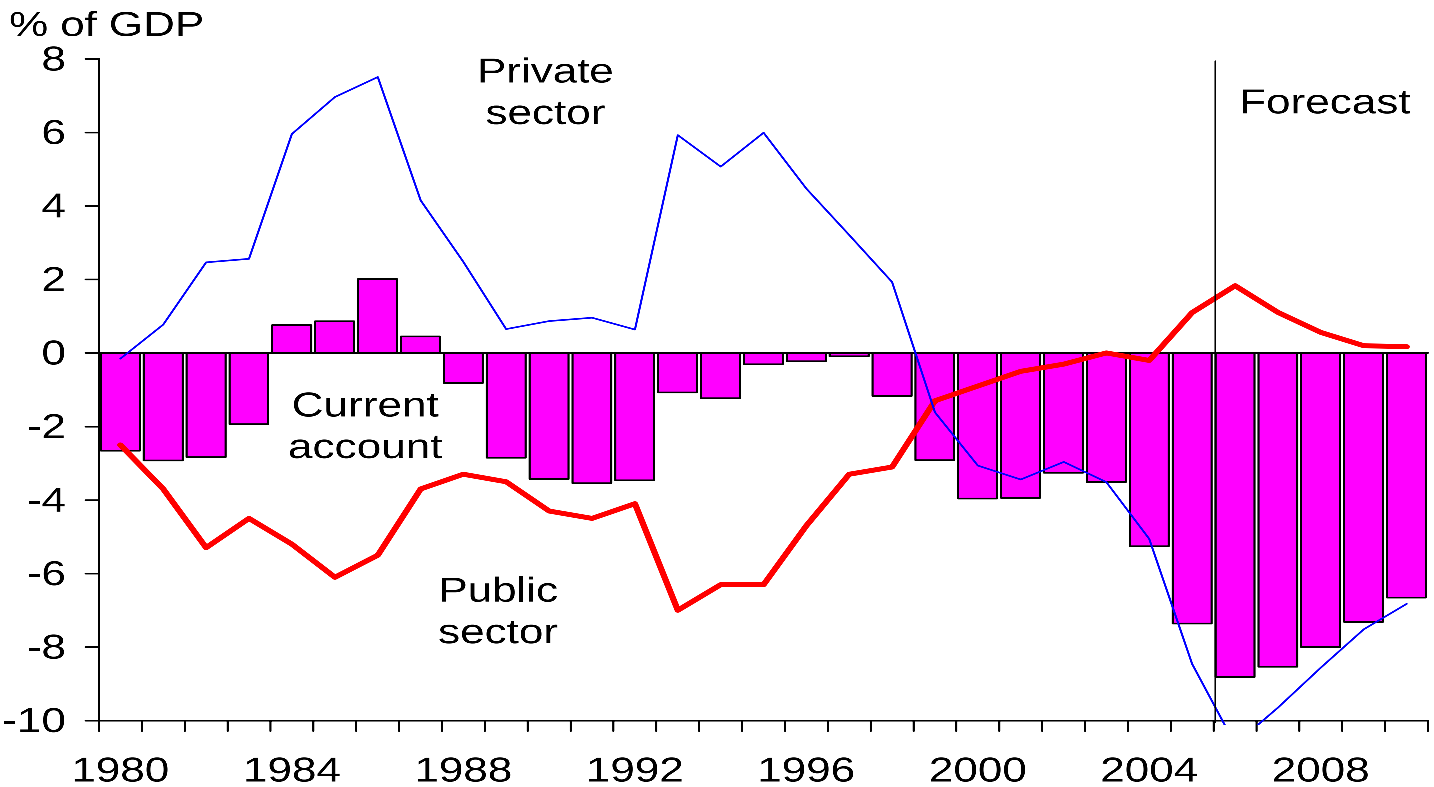
Source: BLS\Haver Analytics\OEF

Germany: Sectoral balances



Source: Oxford Economics

Spain: Sectoral balances



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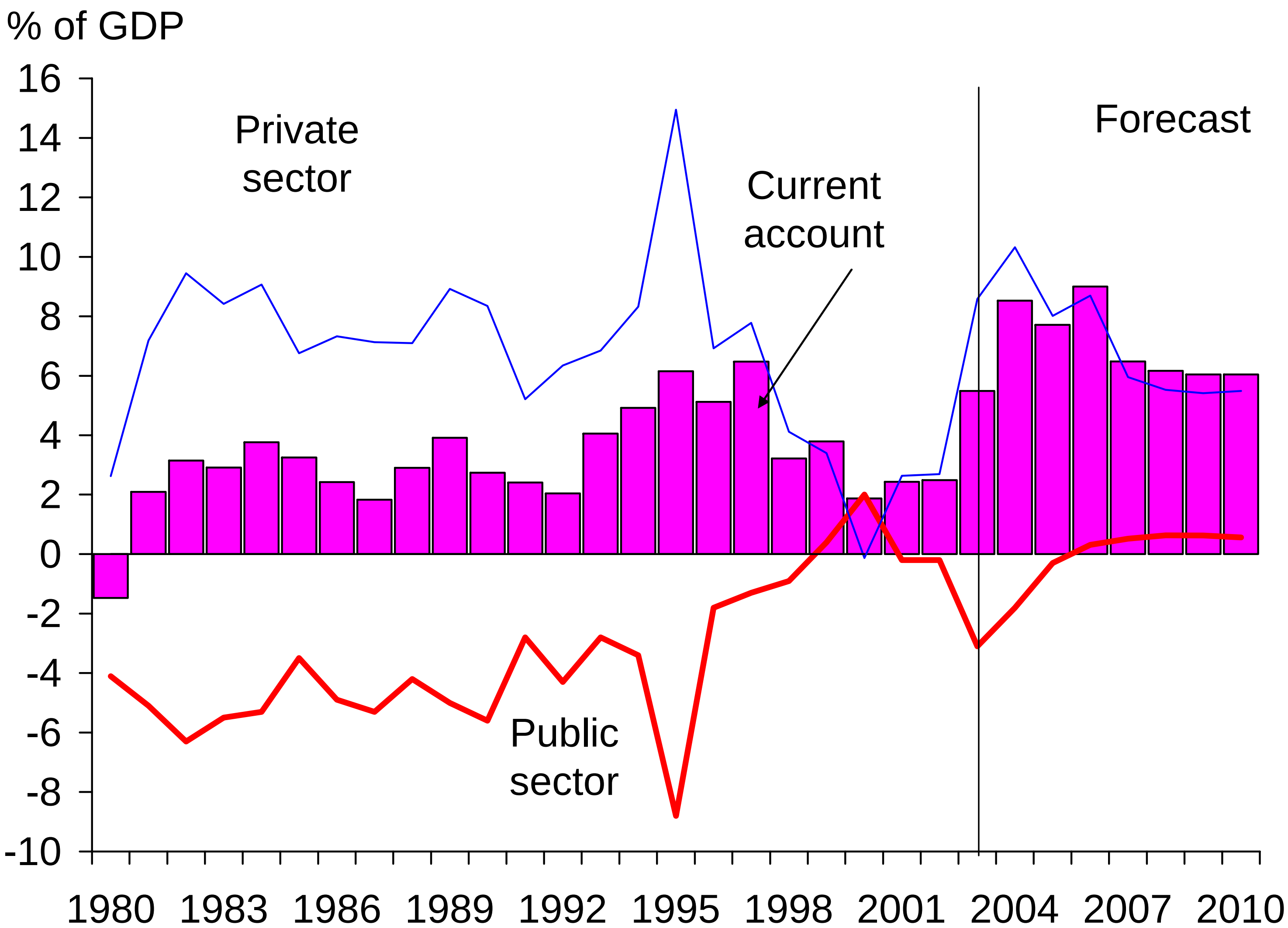

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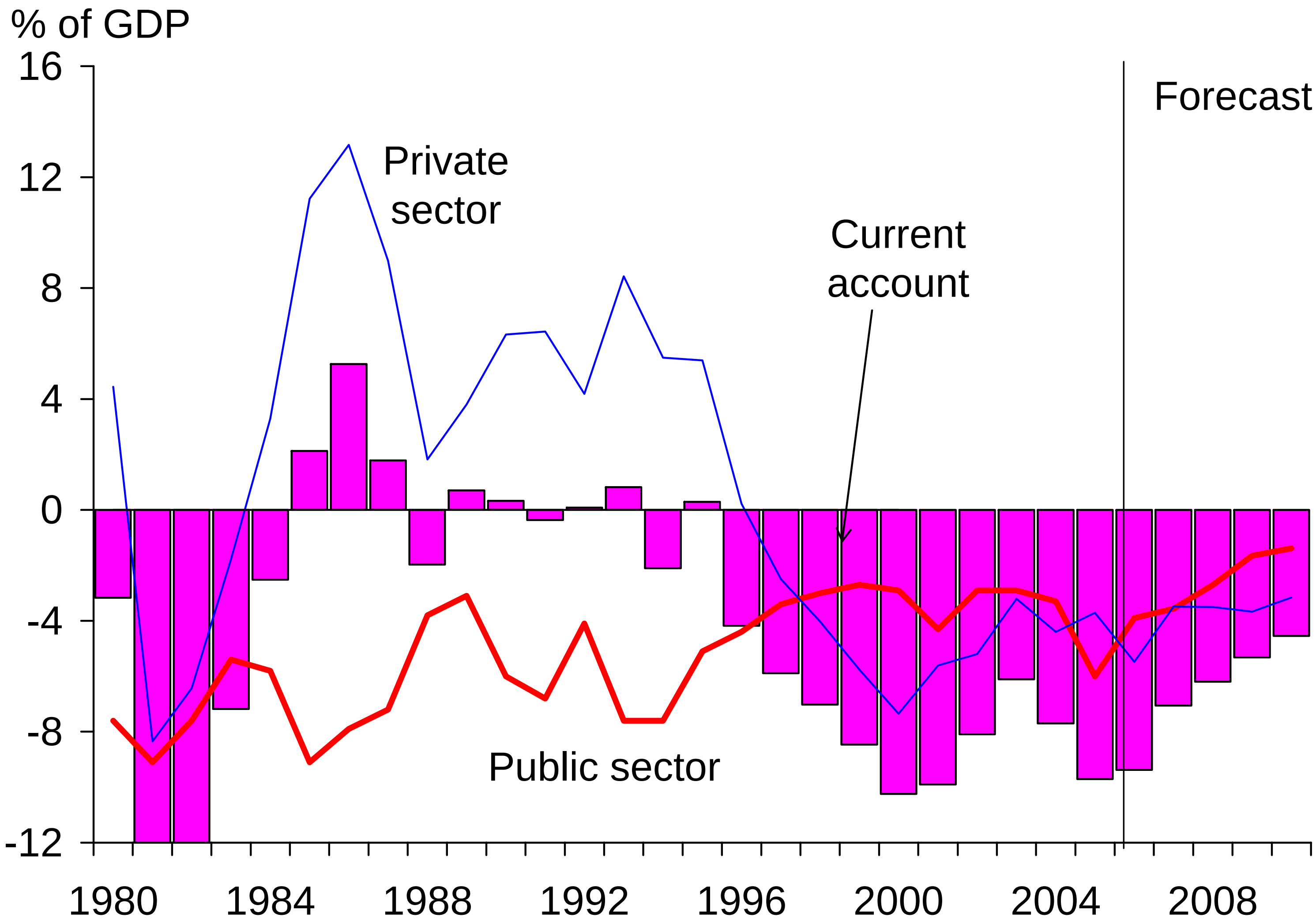
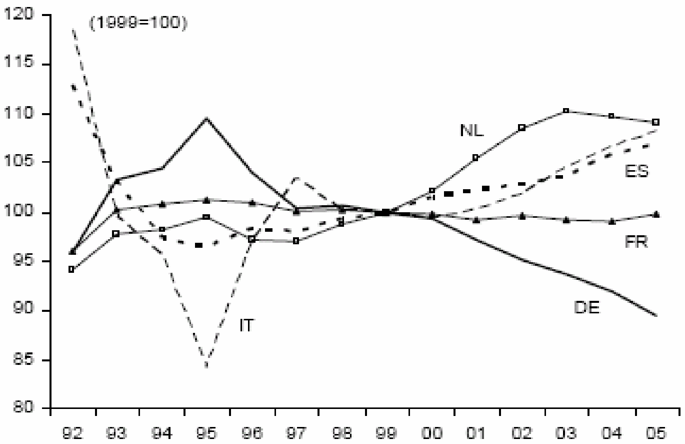
Portugal: Sectoral balances



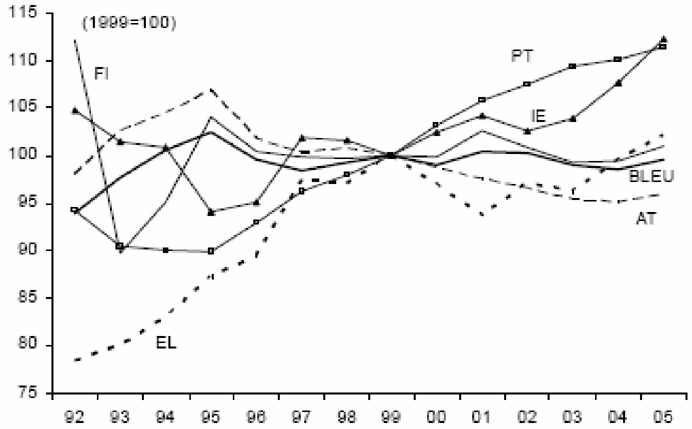
Source: Oxford Economics

Graph 1.12a: Real effective exchange[1] rate vis-à-vis the rest of the euro area (1999=100) – Germany, Spain, France, Italy and the Netherlands



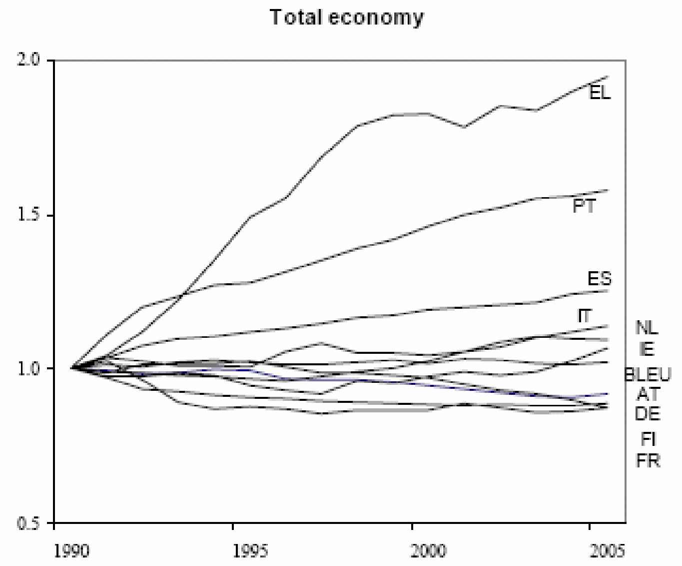
Note: 1 - Index based on nominal unit labour costs in the total economy
Source: Commission Services

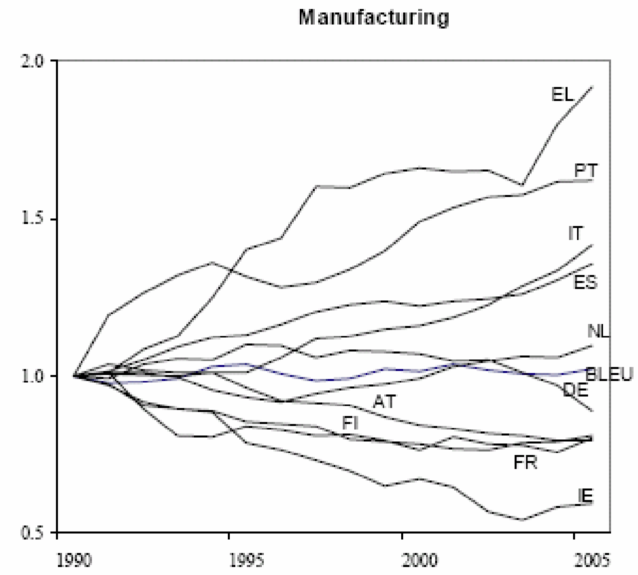
Graph 1.12b: Real effective exchange[1] rate vis-à-vis the rest of the euro area (1999=100) – BLEU, Greece, Ireland, Austria, Portugal and Finland



Note: 1 - Index based on nominal unit labour costs in the total economy
Source: Commission Services

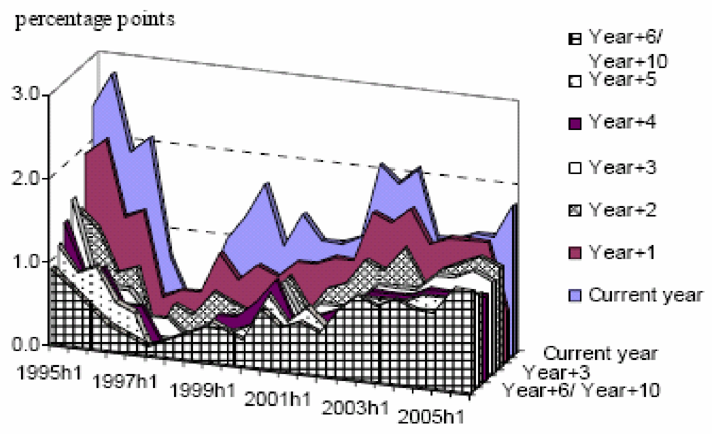
Graph 7: Trade-weighted relative unit labour costs in the euro area (index: 1990=1)





Note: Weights are based on bilateral trade against euro-area trading partners.
Source: Commission Services

Graph 7: Expected real interest-rate differential, Spain and Germany



Source: Consensus Economics and own calculations

The increasing sizes of the slices show that the expected real interest rate differential is larger for short horizons, suggesting that at short horizons *ex post* real interest rates might be quite similar to *ex ante* real interest rates, whereas at longer horizons ex-post real interest rates exceed ex-ante rates.[9] For longer-term horizons the expected differential is relatively small but it has increased to about one full percentage point (or 100 basis points) during the first seven euro-area years. This steady increase had been hidden behind the more moderate averages in tables 1 and 2. The V-shape of all slices indicates that convergence of long-term inflation expectations was only observed in the run-up to the third stage of EMU. For the more recent period the data suggest a substantial permanent real interest rate differential at all horizons. The argument that long-term inflation expectations converge towards the upper limit in the ECB´s definition of price stability does not receive strong support from these findings.