

Conference on European Economic Integration

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What Is This Talk About?

- The Rebalancing Challenges in Europe—Perspectives for CESEE
- Go back to first principles and give a large-scale overview
- Why is there a need—an urgent need—not just for higher aggregate demand but also for large-scale and rapid sectoral rebalancing in CESEE?
 - Also in NEE, SE, and NE too...
- Hope is that an overview will illuminate the context of our panels today on monetary policy, balance-sheet adjustments and growth, macroeconomic imbalances and inequality, external rebalancing, and banking-sector regulation

The Very Long-Run Perspective

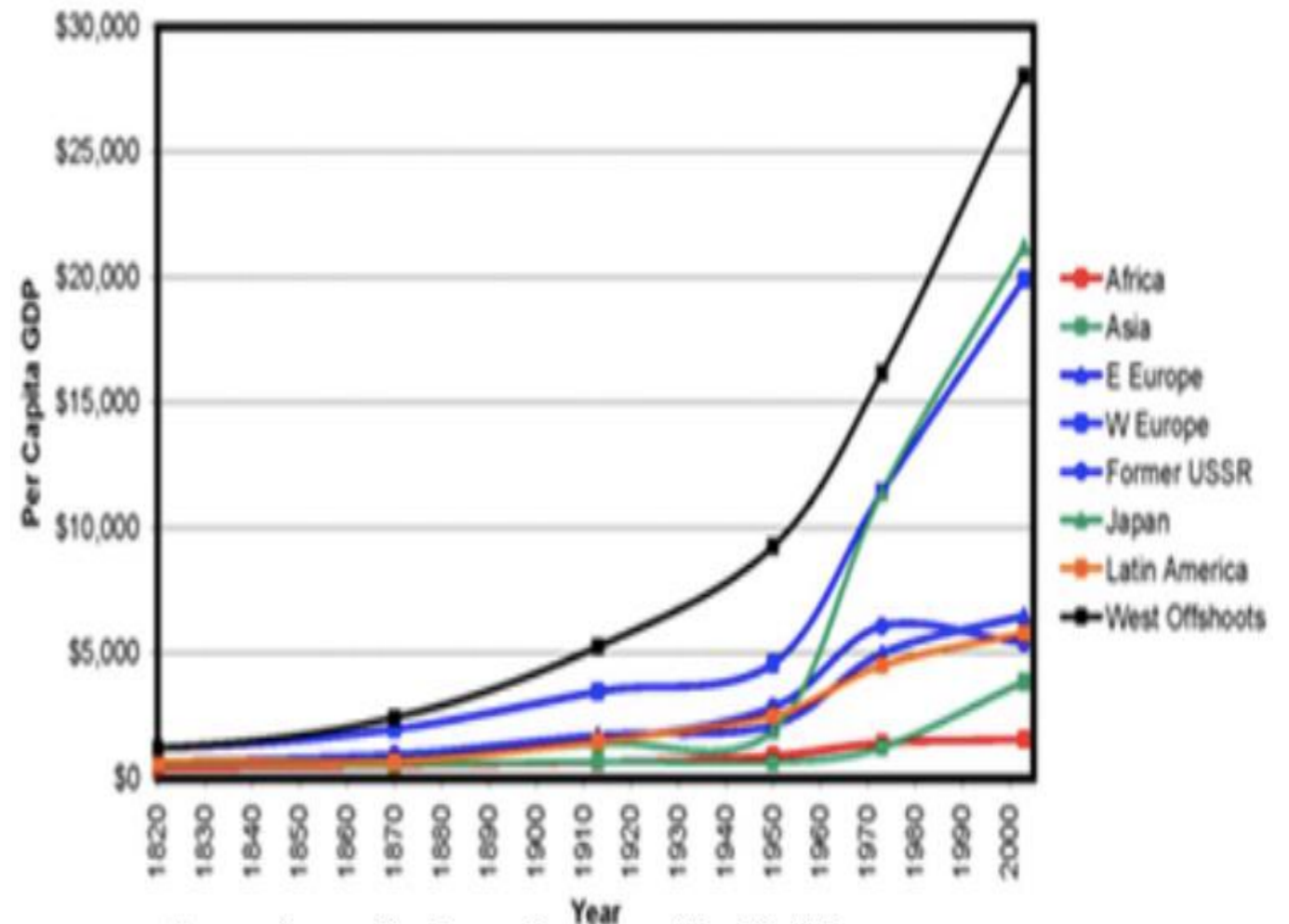
- Do not forget how good news has been since:
 - 12-11-1863
 - 18-6-1815
 - 19-11-1942
- Leopold, Metternich, Adenauer, de Gaulle would not forget



An Unprecedented Success in Integration and Growth

- Since 1945, peace and prosperity on a scale not seen in millennia
- Not since the Cimbri and Teutones crossed the Danube here in 113 BCE
- Even with what happened in FYRs and Stalin's legacy

Per Capita GDP by World Region
1820 - 2003 (1990 Int'l Dollars)



Source: Angus Maddison, Contours of the World Economy

The Problems Are Large, But Small Relative to Achievements

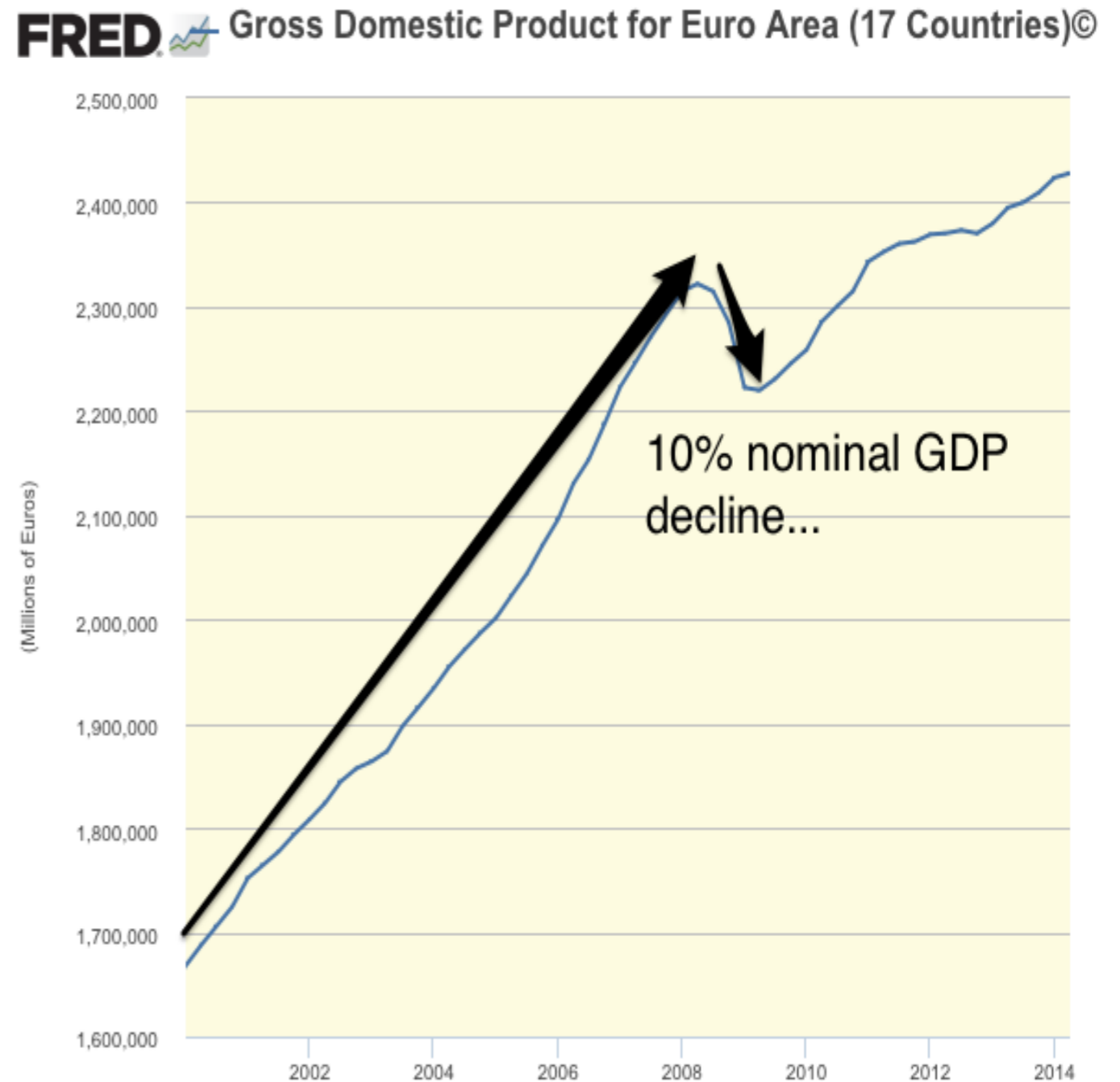
- **Political:**
 - Incorporating ex-superpowers
 - Building institutions for governance in the late Westphalian age
- **Economic:**
 - Grasping enormous fruits of continental integration...
 - Slow convergence in both east and south...
 - The shock of 2008 and its aftereffects...

The Global Context

- Global savings glut/global investment shortfall/global overleverage/global risk-tolerance shortage
- No Keynes-Kindleberger global hegemon in Washington any more
- No equivalent local continental conductor focused on balancing demand the potential supply for the continent as a whole
- Not entirely clear what a Keynes-Kindleberger global hegemon would do—if there were one

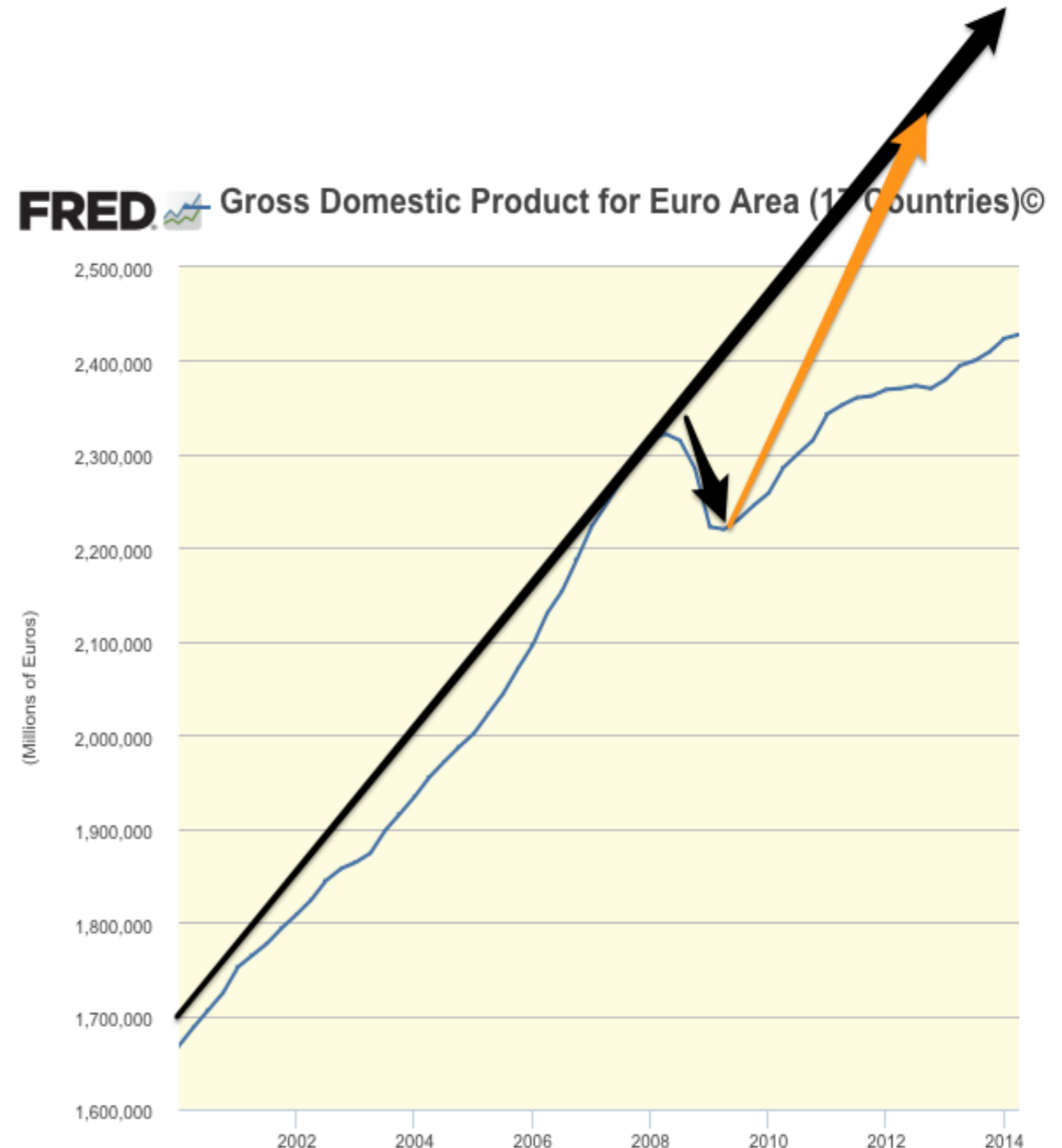
The Shock of 2008

- Best viewed as collapse in risk tolerance across North Atlantic
- Triggered by collapse of U.S. housing bubble, imprudent lending into bubble, and regulatory arbitrage via securities created in that bubble
- Good and bad: savers no longer easily fooled, savers no longer bearing risk



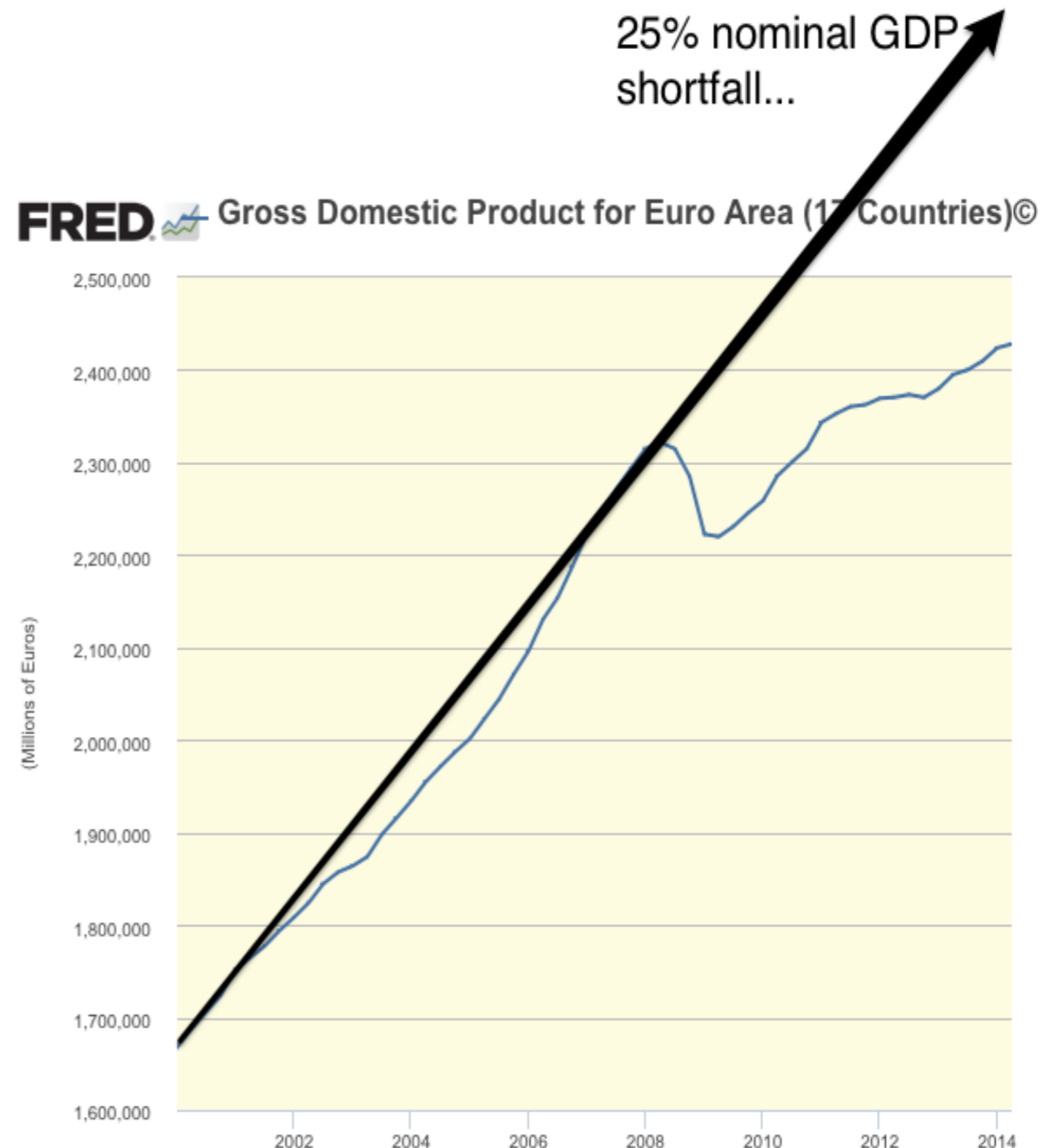
Depression and Recovery

- A shock that boosts demand for liquid safe savings vehicles triggers a sharp downturn
- But we expected quick recovery
- When the water is calm again, what was profitable before is profitable now
- And so economy simply re-knits its old division of labor



Failure of Recovery

- And so the economy re-knits its old division of labor
- Not true this time
- Since there has been no recovery of risk tolerance
 - Does anyone think there should be full recovery?
- Previous division of labor cannot be sustainably reknit.



Consequences for Europe

- Pre-2008 European “convergence” equilibrium employed peripheral labor in extremely risky enterprises—construction, etc.
 - I am being polite
 - As risk tolerance is high, those enterprises were valuable
 - Or perceived to be valuable
- Hence equilibrium real wages in southern (and eastern) Europe high relative to productivity in producing tradables
- This comes to an end in 2008

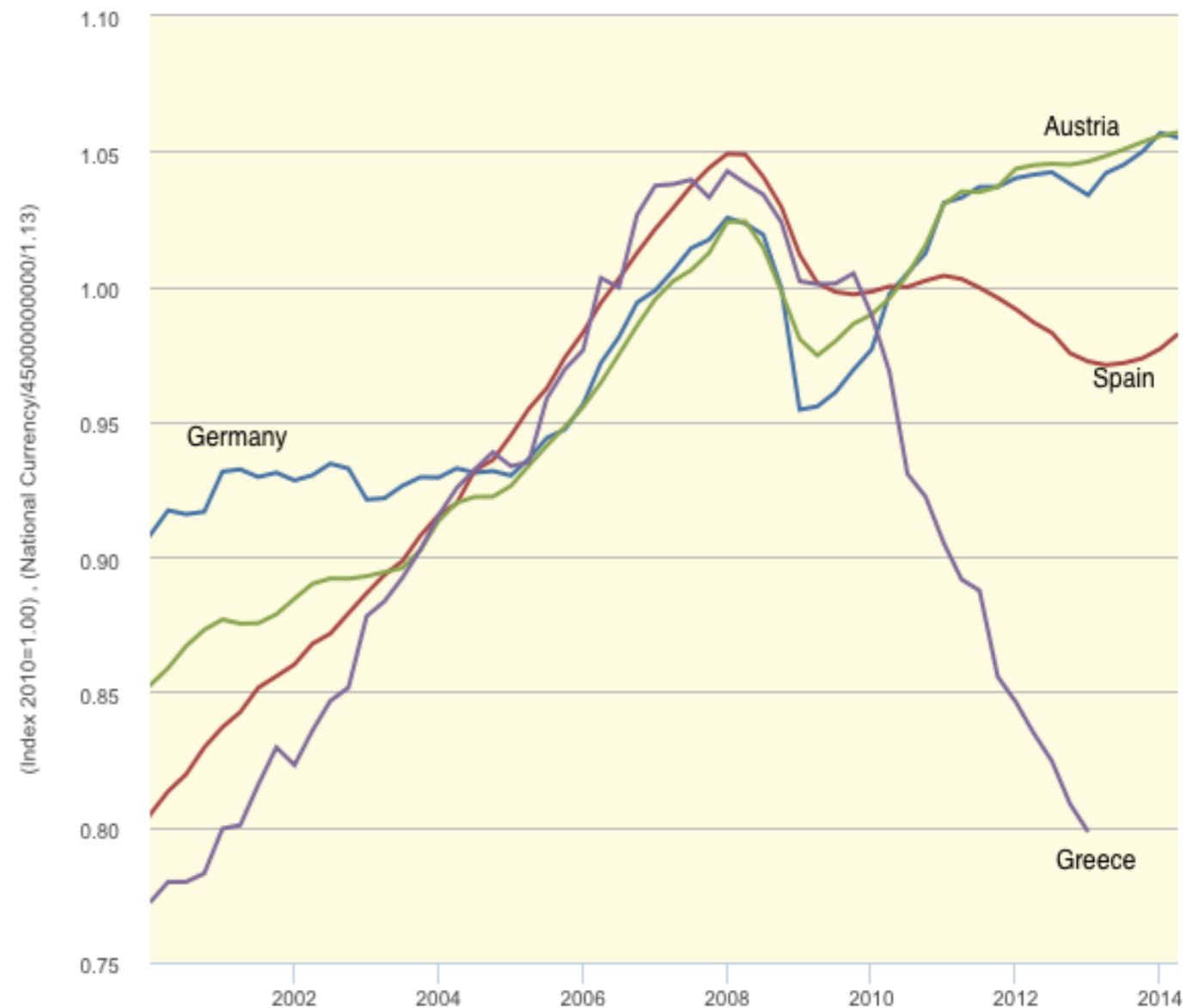
To Attain Full Employment, Peripheral Workers Must

- Find something *safe* to do—that doesn't require Eurocore risk tolerance—profitable at current wage levels
- Reduce wages to levels where they match productivity making tradables: via peripheral devaluation, peripheral deflation, Eurocore inflation, or all
- Increase tradables productivity via structural reform—until it matches wages
- Restore financial market risk-tolerance
 - Not to go-go levels, but to something greater than now
- Use the government to mobilize the risk-bearing capacity of taxpayers
 - Which the equity return premium suggests is vastly greater than that mobilized by financial markets

Or Else

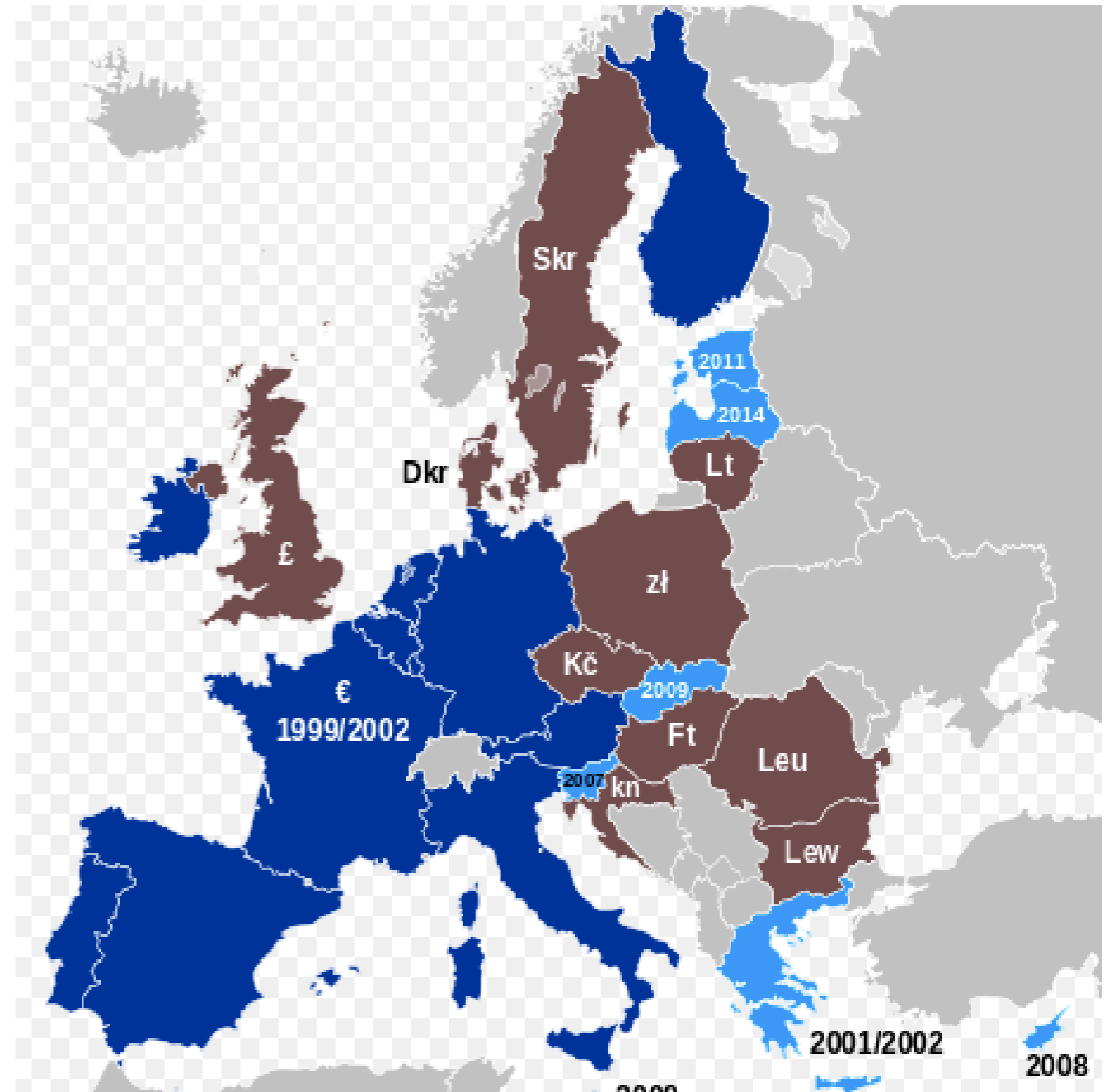
- Long depression, either:
 - Mitigated by large-scale transfers to hold the eurozone together, or:
 - Producing political pressures that may well set European economic integration into reverse
 - And nobody wants to see that

FRED 



Is Devaluation Effective Medicine?

- Devaluation is very effective medicine
 - Until it isn't
- But once-in-a-century global systemic shocks are the time to try it
 - As long as devaluation-tolerance has not yet taken hold
 - How can we know if it has?



Within the Eurozone, Where Internal Devaluation Is Not a Possibility

- External devaluation?
 - Does not resolve structural adjustment problems, but makes life pleasant for Germany as they are resolved
 - Requires support from U.S., East Asia for combined devaluation and global reflation
- Replace missing risk-tolerance via large-scale loan guarantee, asset purchase, or public-spending to create spending in which peripheral enterprises can participate
- “Structural reform”
 - Is “structural reform” harder when unemployment is high or when it is low?
- Europeripheral deflation
- Eurocore inflation
- **If not, then:** large-scale long-term transfers to hold the eurozone together

But Among the Four

- Which are:
 - Large-scale loan guarantee, asset purchases, or public-spending programs to create safe peripheral enterprises—or, rather, spending in which peripheral enterprises participate
 - Structural reform to boost peripheral productivity
 - Europeripheral deflation
 - Eurocore inflation
- Why choose? Not substitutes, but complements

The Curious Political Economy of Europe Today

- In which boosting demand for the production of the europaeriphery, structural reform, eurocore inflation, and peripheral deflation are viewed as either-or substitutes...
- Rather, attempt all--with a willingness to reverse course on whichever appears costly as implemented...

How Difficult Is This Dive?

- “Secular Stagnation” and the “Global Savings Glut”
- Problem was that the global savings glut was a generator not of cheap finance for investment but rather of overleverage—and the collapse of risk tolerance
- “Secular Stagnation” is the wrong phrase:
 - Alvin Hansen’s secular stagnation was technological exhaustion
 - Larry Summers’s secular stagnation is a very large gap between the average (risky) rate of profit and the (safe) interest rate on government debt.
 - A gap that, after 2008, nobody wants to see narrow again *via anything that can be seen as a bubble*