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

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.

25% nominal GDP shortfall...
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
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 europeriphery, 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