Transatlantic economic challenges in an era of growing multipolarity

Conference, 27th September, 2011, Berlin

The conference organized by Bruegel jointly with the Peterson Institute in Berlin brought together policymakers and economists from both sides of the Atlantic. During the nine hours spent at the European School of Management and Technology, the venue for the event, the participants discussed the Euro crisis, its implications for the United States and Europe, the state of the international monetary system and the growth prospects of world economies.

Jean Pisani-Ferry, the Director of Bruegel, introduced the morning session, welcoming guests to the conference and then handing over to **Otmar Issing**, former member of the executive board of the ECB. Mr. Issing then introduced **Vitor Gaspar**, Finance Minister of Portugal, fondly recalling their collaboration at the ECB and describing him as "an extraordinary economist."

Mister Gaspar recounted the events of the early 1950s, when the first multilateral international organizations were created. Back then, the dominance of Europe, the US, and other Western Offshoots, controlled more than half of world GDP, as well as considerable shares of global finance and trade. Forecasts for 2050 paint a remarkably different picture, one in which Asian influence is considerably expanded and the reach of the West diminished. World leaders will have to adapt to a changing balance of power. Mr. Gaspar encouraged the development of a cooperative and multilateral approach to ensure a smooth transition to the new developments.

Mr. Gaspar then discussed what the IMF currently regards as the two most significant risks for world economic prospects. The first one was the possibility that the Euro area crisis would escalate out of control. The second was a deterioration of the situation in the US, due to an impasse over fiscal consolidation, a weak housing market or deteriorating financial conditions. The prospects of recession and contagion effects to other countries would loom large if either of these scenarios became reality.

The involvement of a wider number of world powers in global economic debates was also identified as a key issue on the global agenda, with the G20 meetings being a step in the right direction. Drawing inspiration from Adam Smith's ideas, Mr. Gaspar then highlighted the idea of pessimistic realism, according to which independent nations are suspicious of each other and display no interest in engaging in cooperation. Mr. Gaspar thus argued that parties on both sides of the Atlantic need to prove that this pessimistic realism is not a concern for today's economic scene and that they are willing to build cooperative relations.

Spurred by the lively debate that ensued after his speech, Mr. Gaspar then went into more depth with regards to pessimistic realism and argued that the EU has in fact successfully shown that it is in the interest of sovereigns to communicate with each other in order manage potential conflicts. He concluded that the agents of change of this new multipolar world would have to be the actors of policymaking themselves.

Mr. Gaspar's opening speech was followed by the first panel, entitled "Europe, the US , and the International Monetary System". Chaired by **Jakob Kirkegaard**, from the Peterson Institute, the session included presentations of papers by **Ignazio Angeloni** and **André Sapir** "The international monetary system is changing: What opportunities for Europe?", and **Joseph Gagnon**'s work entitled "European Monetary Unification: Precocious or Premature?"

Mr. Sapir argued that the crisis had brought back to the fore the discussion about the international monetary system. Even though the link between the crisis and the system was not clear, the system had some part to play in the developments of the economic crisis. Since the breakdown of the Bretton Woods system, the new monetary system was meant to deliver internal and external balance. Disciplined macroeconomic policies were expected from the US, and the free flow of capital would be restored. Free capital mobility however had been recently questioned.

There was dissatisfaction with the international monetary system (IMS) even before the crisis, but the crisis had brought to the fore some of the underlying problems in the current IMS. The authors identified three shaping factors of the IMS: the size of nations, the ability to exercise monetary leadership and the global financial conditions. These were then followed by three potential scenarios in future developments of the IMS: a repair and improve of the current system, including the elimination of some of the current shortcomings, a market-driven and policy-driven system towards multipolarity, and a multilateral system based on the SDR. Some natural steps that are likely to follow are an initial repair and improve plan, followed by either the second or the third scenario, the authors suggested.

Mr. Angeloni briefly addressed the Triffin dilemma, which brings to the fore the problem that the hegemon country in an IMS needs to run a deficit in order to provide liquidity, but that this in turn lowers his credibility. As a result, a desire arises to diversity away from the hegemonic currency, which in the case of the world economy was the US dollar. Hence focus is shifted towards other potential candidates, such as the Euro or the Renminbi.

The advantages and disadvantages of a system in which there is one hegemon were also addressed. One hypothesis is that there could emerge hegemonic stability, in which the hegemon internalizes any externalities, and is therefore more stable than an alternative multipolar system. This scenario is similar to that of a monopolist in the theory of the firm Contrasting theories suggest however that the hegemon could also exploit his monopolistic power, leading to undesirable consequences.

The discussion also focused on the potential competition between the Euro and the Renminbi. The Chinese have already taken a few steps to promote the international use of their currency. This is reminiscent of the way the dollar gained an international role, namely by increasing deposits of the currency and creating a new bond market, among others. A possible scenario highlighted by the paper is one of a tri-currency system, with the Euro and the renminbi existing alongside the dollar.

Joseph Gagnon's paper considered the level of European integration and found weak evidence for its increase since 1999. Mr. Gagnon, from the Peterson Institute, argued that countries in the Euro area remain considerably less integrated than regions or states within the United States. He thus found that even within the core of the Euro area, average inflation rates and unemployment rates differed much more across countries than they did across regions of the United States. Shocks to unemployment in the core of the Euro area were also noticeably more divergent and persistent than in the United States. To conduct the analysis, his paper focused on the unemployment rate rather than output growth, following the reasoning that differences in output growth are not necessarily indicative of a lack of economic integration.

Commenting on the papers of the first session, **Adam Posen**, of the Bank of England and the Peterson Institute, pointed out that there are different generational points of view with regards to the evolution of the IMS, between those who either saw the Bretton Woods agreement being implemented and witnessed its fall, and those shaped more by the arrangements that followed the system. He also addressed the point that people often complain about the exorbitant privilege of the US, but that little attention is paid to the fact that some European countries have also enjoyed this privilege at some point in their development. Examples include the UK and Spain. His personal stance on the next step in the development of the IMS was that the current system should be preserved with some adjustments, while accepting perhaps a receding role of the US. He further stressed that the emergence of a rules based system at the international level is highly unlikely. "It is impossible to place nation states behind a Rawlsian veil of ignorance", he argued. Mr. Posen concluded that not only having some resolution to the current Euro area crisis is important, but also that the way in which the crisis is resolved matters.

The second panel addressed the growth challenge in Europe and the US and was chaired by Jean Pisani-Ferry. The papers presented were written by **Zsolt Darvos**, research fellow at Bruegel, and **Michael Mussa**, from the Peterson Institute, and considered the growth problems on both sides of the Atlantic. Mr. Mussa's paper, "Challenges to Economic Recovery in the United States and Europe", was introduced by Jakob Kirkegaard, since Mr. Mussa was unable to attend the conference.

Mr. Mussa's paper looked at why the US and Western Europe had experienced slow recoveries, and considered the prospects for their economic growth. He warned about a slowdown in consumption and domestic demand in the US and gave a medium term forecast of growth in aggregate demand of less than 3 per cent. The supply side of the economy still has a large output gap, and there is also a severe long term unemployment problem. Mr. Mussa further highlighted the fact that differences in domestic demand and GDP growth lead to current account imbalances. An overall pessimistic outlook on the economy was expressed, as Mr. Mussa argued that deep rooted policy issues have an impact in the short-term and there isn't much that policy-makers can do about that. The overall conclusion remained that both the US as well as Europe still struggle with difficult problems. The two areas remain similar in that they both require medium-term fiscal consolidation, but they are also different in significant respects. The wide disparities in the economic problems of the Euro area members, together with the constraints of a unified currency, among others, make the prospects of medium-term economic growth more questionable for the Eurozone.

Zsolt Darvas then went on to focus more closely on growth in the EU. He presented 5 regional groupings of EU countries, namely the North (Denmark, Finland, Sweden, Ireland, UK), West (Austria, Belgium, France, Germany, Netherlands), South (Greece, Italy, Portugal, Spain), East-Core (Czech Rep., Hungary, Poland, Slovakia, Slovenia) and East-Periphery (Estonia, Latvia, Lithuania, Bulgaria, Romania).

The current economic context is one of low growth and high levels of debt, Mr. Darvas argued. Troubled countries are unable to supply fiscal stimuli, while the Eurozone countries that would be able to do so will not supply more fiscal support. The ECB is also reluctant to implement more monetary easing. Mr. Darvas commented that growth and investment are lower than in recoveries with credit, that the industries more reliant on external finance seem to grow disproportionately less during credit-less recoveries and that credit-less recoveries are typically preceded by banking crises and sizeable output falls. The literature up until now has not paid attention to real exchange rate developments during credit-less recoveries.

There has been a legacy of severe weaknesses in the tradable sector, of overvalued exchange rates, of slow adjustment in private sector wages and of distorted capital allocation in several South and East-Periphery countries. To remedy some of these issues, more attention should be given to supply-side conditions. This could involve direct policies toward the tradable sector (structural policies, macroeconomic stability, FDI promotion), labour markets (employment, education, immigration), improved competition (product/labour markets), controlled real exchange rate appreciation and an improvement in the business climate.

Mr. Darvas argued that the unused EU structural funds could be exploited in a more efficient way. This could be done for instance in Greece, where they amount to 10 per cent of GDP, and would represent a viable financial resource. Mr. Darvas also remarked that the economic sentiment indicator was falling for all areas of the EU. Looking at the numbers for domestic credit, Mr. Darvas found that there hadn't been much increase in credit overall, there had been some promising steps in the West. Big discrepancies were however present in the Northern group, with Sweden experiencing credit growth, while Ireland was going through a shortage in credit. A similar phenomenon was also present in the Eastern group, with growing credit in Poland, and very little credit in Hungary.

Mr. Darvas also remarked that in most of Europe convergence had stopped in the 1970s. He also remarked on a rapid unit labour cost increase and on the fact that there was a sudden current account balance adjustment in the East periphery. This was not the case in the South, which is additionally in need of urgent structural reforms.

European discussant **Małgorzata Kałużyńska**, from the Polish Government, argued that the EU struggles to overcome the crisis focusing on reforming economic governance, and that this is also seen as a solution for the growth problem. She expressed her doubts about whether this would be sufficient. She then went on to suggest that both the EU and the US were likely to come under the attacks of emerging economies, and that the EU would have to defend and consolidate its economic performance and its contribution to economic growth.

US discussant **Rajshri Jayaraman**, from the European School of Management and Technology**,** reinforced some of the worries expressed by Mr. Mussa in his paper. She highlighted that indeed consumption growth in the US was slowing, savings were increasing, the value of equity had gone down, there was a collapsing housing market and that state and local spending was in decline. Furthermore, residential investment had decreased, unemployment rates for high school graduates were at a 30 year high, although, among those with a college degree, employment had actually increased. The worry remained however that there may be a systematic mismatch between the skills needed and those offered by the labour market. Additionally, manufacturing capacity in the US was shrinking, and even once the recovery kicked in, capacity constraints could still hinder progress in the manufacturing capacity.

Mr. Kirkegaard then addressed some of the issues raised by the discussant, suggesting that most of US unemployment was cyclical in nature, but that structural factors also mattered. The issue of the US labour markets was then considered in more detail. Although there had been a substantial creation of jobs in some sectors, in the class of mid-wage administrative jobs little progress had been made, particularly due to certain jobs being replaced by technological advancements. Additionally, people who had lost their jobs during the recession faced faster skill depreciation, and future hysteresis effects in the US labour market were also likely.

Following the second panel was the discussion of the keynote speaker, namely **Wolfgang Schäuble**, the German Federal Minister of Finance. Mr. Schäuble drew attention to the effects of interest rate cuts and fiscal spending policies, primarily in Anglo-Saxon countries. Some of these effects included the emergence of debt and imbalances. Remarking that governments and central banks had up until now used up much of their fiscal and monetary power, Mr Schäuble argued in favour of a policy framework that does not encourage the laissez-faire economic policies of the recent past, and which manages to avoid marginal economic growth and highly speculative markets. For growth to ensue, he called for immediate fiscal consolidation and structural reforms in highly indebted countries.

He further agreed that financial assistance had to be given to indebted countries. “In essence we are buying those countries some time, as they need to put their public finances on a sustainable footing,” he argued. He also suggested that one of the main problems of these countries was their large current account deficit, which in turn exposed a lack of competitiveness. He then called for an immediate fiscal consolidation and for structural reforms in Italy, Spain, Portugal and Greece. Public finances had to be adapted in such a way as to ensure future growth. The confidence of both citizens, as well as of markets, had to be restored.

Mr. Schäuble also emphasized the importance of solidarity between countries in the European Union, while stressing that this solidarity could only accompany countries’ efforts for change, and could not substitute them. He further stressed looking beyond government budgets, debts and deficits, and considering individual economies, in an attempt to improve competitiveness and better coordinate economic policies. Ultimately, in order to create lasting and sustainable growth, some preconditions had to be fulfilled. Mr. Schäuble defined sustainable growth “as steady, environmentally friendly and socially competitive growth.” Quoting Karl Popper’s concept of an open society, Mr. Schäuble argued in favour of an improvement through a constant process of trial and error. “If we want to draw the right lessons from the Greek crisis, that is how we have to proceed,” he argued.

In the discussion that followed his speech, Mr. Schäuble illustrated the fact that it was always easier to give advice to other countries than to give advice to oneself, he thus light-heartedly suggested that he is well prepared to give advice to the US government. He went on to argue that one cannot fully rely on monetary policy and that the ECB was not like the Federal Reserve, in that it does not have to focus as much on growth and labour markets. He then went on to identify some key problems of the Euro area, such as volatility in markets and the danger of contagion. He also stressed that if the EFSF would be enhanced, this would have to be done in the most efficient way. However, policy makers ought to remain cautious, as increasing the size of the Fund would threaten the credit rating of certain Euro area countries, he argued. Mr. Schäuble further suggested that the European Parliament was not sufficiently prepared to convince and coordinate national sovereigns.

Guntram Wolff raised the point that if structural reforms are implemented at this point, hardship would be imposed on large parts of the population, undermining political stability, especially in Southern Europe. Greece would be likely to need more time before these reforms are successfully introduced.

The third and final panel discussion followed Mr. Schäuble’s discussion. The session was chaired by Zsolt Darvas, and was centred on the debt challenge in Europe and the US. **Alan Ahearne**, from Bruegel, and Guntram Wolff presented their paper entitled “The Debt Challenge in Europe”, and were followed by Jakob Kirkegaard with a study on general government indebtedness and an investigation into whether there is a role for the asset side.

Focusing on the corporate sector, Mr. Wolff argued that the debt challenge had two core components, the debt overhang and a price adjustment need in peripheral Eurozone countries. There was a significant divergence in price competitiveness in the Eurozone, with Germany having gained competitiveness relative to the Euro area partners, although the gain was smaller in absolute terms. At the same time, manufacturing as a share of value added had decreased. In terms of the net lending position of the non-financial corporate sector, the Eurozone found itself at a level at which it had never been before, with the non-financial sector giving money to the rest of the economy, a sign of balance sheet adjustment.

Mr. Ahearne addressed the issue of household debt. There had been a considerable increase in household debt from 1999 to2009 for most of the EU 17, other than Germany, whose level of debt was still below the European average. Finland, the UK and Sweden however had successfully reduced household debt, with growth and a rise in disposable income being the main drivers of this success. Discussing potential policy implications, the authors found that successful deleveraging would be very difficult to achieve without growth and without a solution of the current crisis.

Mr. Kirkegaard then introduced his paper. He focused on the net level of government debt, more specifically on financial and non-financial assets and the role they play in solving the crisis. He argued that Ireland had witnessed the largest fiscal effects of financial market interventions. Excluding Ireland, Germany experienced the highest amount of distressed private financial assets/liabilities transferred to the general government in the EU. Meanwhile, through the takeover of Fannie Mae and Freddie Mac, the scope of the U.S. federal government reception of previously private financial assets during the crisis significantly surpassed interventions in Europe, again excluding Ireland.

In terms of future fiscal consolidation, Mr. Kierkegaard called for efforts on both sides of the Atlantic. He concluded nonetheless that the "asset side of governments' balance sheets" can provide only nonessential assistance to this effort. Asset divestments cannot provide enough relief for the high debt of Europe and of the US, since the two regions lack sufficient assets for this purpose.

Clemens Fuest, from Oxford University, went on to discuss the papers and made reference to a simplistic vision of the world in which there are two types of consumers, patient (savers) and impatient (borrowers). One category takes on debt, while the other saves. Borrowers thus use the money for consumption. After a while savers stop lending to the borrowers, who now have to cut down consumption, which becomes a negative demand shock. He argued that lacking the option of implementing a fiscal stimulus, balance sheets need to be addressed directly. One needs to look at the entire balance sheet of the borrower and see if any of the assets can be sold. Growth prospects are poor and there is an uncomfortable conflict looming between savers and borrowers, not only within countries, such as Italy, but also between countries. "The political challenge is to look for ways of moderating this conflict", he concluded.

Michael Burda, of Humboldt University, argued that leverage is not causal to growth and that getting competitiveness back is not sufficient for getting sustainable growth. Just cutting spending in Greece would not have significant effects. Something needed to be done about the supply side. This could be achieved by means of interest rates, or by carrying out privatizations and reforming labour markets.

Mr. Wolff continued the debate by addressing the issue of the liquidity trap. If interest rates are close to zero, there is missing demand which needs to be filled by fiscal policy. He further argued that deleveraging would have to be done through debt restructuring. Growth is central for the deleveraging and this will not only come from fiscal policy. These comments concluded the third panel.

The final panel was chaired by Mr. Wolff, and presented a review of opinions and lessons that could be taken away from the conference.

Charles Collyns, from the US Treasury, started by discussing the position of the US and suggested that counter-cylical measures were the focus of international policymakers and that the Federal Reserve wanted to introduce a new twist into its range of weapons. Also some short-run support for the economy was necessary. Obama had announced a major package of fiscal support measures, without this package there would be a very sharp reduction in the US fiscal deficit. The package however should help smooth the withdrawal of stimulus and put the economy on a long run path of fiscal consolidation. In Europe, the key objective at this point was to provide markets with complete assurance that countries of basically sound fundamentals would receive support to allow them to continue borrowing at reasonable interest rates, and also assurance to markets that banks had adequate capital. One key lesson that policy makers should bear in mind is the importance of central banks and fiscal authorities working closely together. For this to work, liquidity was required.

Mr. Pisani-Ferry then continued. He argued that spillovers from the financial markets were significant, and that the US and Europe were tightly connected in that way. He identified two main limitations that prevented policymakers from taking the most appropriate course of action. One was the existence of imperfect knowledge, which meant that the right answer was usually not known. The other involved knowing what the answer was, but being unable to implement it. He went on to suggest that policymakers in Europe were bound by procedure, which is a result of the way the EU was built. There was also a risk of moving to a bad equilibrium due to the debt crisis, and this needed to be prevented. The warning also applied to countries that are solvent under normal conditions, but which could be made insolvent by high interest rates. A solid framework for intervention in problem countries would need to be established and the principles of action on the side of the EFSF clearly spelled out. Furthermore, Greece had to tackle the problem of sustainability quickly.

Mr. Pisani-Ferry then addressed the issue of banks. The connection between banking and sovereign crises, like in Ireland or Greece, was important. A potential solution to the current situation would be to let the banks hold bonds from the Euro area in general and from the rest of the world. This would make banks less vulnerable to the sovereign, while also ensuring that sovereigns are not at the mercy of their banks. Relations between the European Commission and some of the member countries could also be tightened. “At this stage, markets expect policymakers to speak loud and clear”, however policymakers are not able to do that yet, Mr. Pisani-Ferry concluded.

Mr. Posen also contributed to the final debate. He argued that in a case of a crisis, financial resources disappear, and that governments had to face this fact. One solution to the problem was to “go very Austrian”, and as a result suffer the consequences, but macroeconomics teaches us that confidence, debt overhang and the transmission mechanism make the disappearance of the money extremely problematic. Mr. Posen argued that people should recognize that monetary economics still has some uses, and that we are not really in a liquidity trap, which means that monetary policy still has some power. Returning to the point made earlier by Mr. Fuest, about the world with prudent savers and reckless borrowers, Mr. Posen suggested that savers need not be necessarily seen as the good characters in the debt story. “Some savers were bad savers” he argued, “they made bad investments, so maybe it’s not so bad to let them bear some of the burden.”

Antonio Cortina, from Banco Santander, took over the discussion and argued in favour of an expansion of the EFSF. He also addressed the case of Spain an argued that in the 2008-2009 recession, Spain had an evolution similar to that of the Eurozone. There were no significant impediments in its ability to grow however, and growth was now at 1.5-2 per cent. The country was however still dealing with the problem of the housing bust.

On a slightly more optimistic note, Mr. Kirkegaard suggested the possibility of seeing the crisis as an opportunity, as a starting point for putting many things right in the design of the European Monetary Union. He supported this by arguing that the crisis had lead to the reform of Greece, and maybe even of Spain.

As a concluding remark, one key lesson that could be drawn from the crisis is that the international economic architecture needs to be strengthened in order to reduce spillover effects. There was a general consensus that relations between countries on both sides of the Atlantic had to be solidified, as the world economy was faced with a slow recovery, an uncertain debt crisis and a potential redesign of the IMS. Signs of distress, as well as of hope were expressed at the conference in Berlin. Even though caution remains of the essence, policymakers still hinted at a glimmer of hope, suggesting that concentrated efforts could put the world economy on a sustainable growth path.