Sunday, 29 September 2013

Rome: 23rd September

THE PRETENCE OF BARGAINING POWER IN THE EMU:

FRANCE VERSUS GERMANY

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The idea of the promoters of EMU was that by fixing the nominal exchange rate and therefore eliminating the exchange risk, convergence between the stronger and weaker economies that share the euro – the so called “core” and “periphery” – would be achieved through the smooth flow of capital from the surplus to the deficit countries loosening the latters’ external constraint and improving their output capacities and productivity (James, 2012).

And indeed capital flew to the periphery thanks to “European financial market integration acting as a positive credibility shock for southern European countries” The euro allows the periphery and France to live under a ‘soft budget constraint’ where these countries were able to borrow at levels of interest rates similar to Germany while delaying unpopular reforms.

Instead of promoting convergence, the EMU has entrenched the competitiveness gap stemming from differences in inflation rates and relative unit labor costs. Divergence in trade and competitiveness performance has been exacerbated by real effective exchange rate (REER) appreciation, largely driven by nominal appreciation of the common currency post 1999.

Without the “safety valve” of external devaluation, divergent competitiveness can only be addressed in two ways:

- internal devaluation that is “a depreciation of the real exchange rate in the deficit countries via a cut in their unit labor costs, either through higher productivity or lower nominal wages”
- or cross-border financial flows – that is, transfers.

We assume that the only choice for both Germany and France are transfers and internal devaluation short of exiting the euro. France cannot trade off increased output with higher inflation thereby reducing her debt, and can only raise revenue through distorting taxes. The French predicament is the decisive factor determining the outcome of the Euro crisis.

Policymakers in EMU overestimate the cost of EMU exit and ignore the costs of a transfer union in the long term, they lead to a situation where creditors are taken hostage by their debtors.

Determination of relative bargaining powers in the fiscal transfer game – FX Adjustment

To understand the impact of EMU break-up on the economies of the creditors and the debtors we need to assess the degree of currency over/undervaluation and the impact of the currency adjustment on both inflation and economic growth outcomes in each economy.

Based on the evolution of unit labour cost since the euro began trading in January 1999, we determine the degree of the likely currency adjustment following EMU dissolution.

Slide 2 – Table 1

Table 1 – Currency Adjustment Required During EMU Dissolution

Table 1 highlights that the debtor economies would see a significant degree of currency depreciation versus its trading partners following EMU break up. We first need to understand the inflation implications, and then to concentrate on the degree of exports boost such currency weakness could provide.

Determination of relative bargaining powers in the fiscal transfer game – Inflation Impact

The assessment of inflation impact of these currency adjustments can be made by estimating exchange rate pass-through to inflation in the debtor and creditor economies. Our dataset encompasses quarterly data between 1975 and 2013.The lag length of the model for each country is determined looking at a range of information criteria as well as specification tests. The optimal lag length for the economies in our sample is generally between 3-5 quarters.

Based on our previous estimates of currency over/undervaluation, we expect the following incremental inflation impact following EMU break-up (table 2):

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Table 2 – Incremental Annualized Inflation Impact post EMU Dissolution Based on FX Pass-through

Debtor nations would see the necessary boost to inflation expectations at the time of deflation expectations slowly setting in. Germany (a nation of savers) would see a period of disinflation. It is worth noting that the inflationary impact on Italy and Spain is particularly dramatic whereas that on France reasonably muted, highlighting France's relatively greater bargaining power in the process.

Determination of relative bargaining powers in the fiscal transfer game – Exports Impact

A similar methodology is applied to assess the impact of EMU break-up currency adjustments on exports and hence economic growth in the creditor and the debtor economies. We cover the 1975-2013 period.

Based on our estimates of the currency adjustments required, we arrive at the following impact of exchange rate moves at EMU dissolution on exports:

Slide 4

Table 3 –Impact on Exports post EMU Dissolution Based on FX Pass-through

The short-term bargaining power imbalance is clear from both the inflation and the exports picture: France is the biggest beneficiary of EMU break-up and Germany the biggest loser.

However, determination of the true bargaining power can only be conducted by assessing both the short-term and the long-term consequences of EMU dissolution. This gives a much more balanced picture of the relative bargaining powers, as argued in the next section.

Table 4 compares the impact both in the short and long term for Germany to exit the EMU or to continue the fiscal transfer game, while table 5 repeats the exercise for France.

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Table 4 – Germany inside or outside of the EMU?

German EMU exit

The re-introduced Deutschmark would appreciate in value by a significant margin. The most tangible cost of EMU exit is the loss in value of euro-denominated foreign assets of the German public and private sectors as well as a slowdown in trade.

Using our previous estimates, we expect a 12% decline in German exports (equivalent to a one-off GDP loss of 6%) and a lower long-term equilibrium contribution of net exports to GDP (we estimate this as an annual loss of 0.6% of GDP).

Deutschmark appreciation would also lead to a decline in Germany's net foreign assets. By the beginning of 2013, Germany's NFAs exceeded USD 1tn, according to Bundesbank figures (April 2013). 90% of these assets belong to the Bundesbank and 70% of them are in the form of Target 2 imbalances i.e. claims on the banking sectors of the debtor nations. Deutschmark's adjustment against Eurozone currencies of the magnitude we propose would result in a net foreign assets loss equivalent to 16% of German GDP.

A stronger currency following EMU exit would also bring benefits. Germany's fiscal position would improve as euro denominated debts would be lower in value relative to budget revenues denominated in the stronger Deutschmark. The fiscal advantage gained from introducing the new regime could then be used to re-capitalise the banking sector. However, the recapitalization needs are unlikely to be elevated. German banks' net foreign assets stood at a manageable EUR 8bn as of the end of 2012, as the bulk of the burden had been moved to the public sector balance sheet.

Moreover, a persistently undervalued currency – while benefiting Germany's exporting industries – has arguably reduced the real international purchasing power of German households and led to significant declines in the economy's productivity. A stronger currency following EMU exit would limit Germany's price competitiveness and decrease its contribution of net exports to GDP growth. Germany is currently running current account surpluses of around 6.5% of GDP, well above the levels seen in China and Japan and a stronger currency could be seen as Germany's contribution to global macroeconomic rebalancing.

Furthermore, growth in Germany's output per worker has been in decline since Germany became part of the EMU. A stronger currency would motivate German businesses to generate productivity gains. It would also allow Germany's households to benefit from greater international purchasing power without the need for wage inflation.

Fiscal Transfers game continues

We estimate that the cost for Germany would amount to 2% of German GDP transfers to France each year (financing public and private sector dis-savings), assuming that no major reforms take place in France and taking the current account deficit as the direct proxy for the dissaving in both the public and the private sectors. In the event that France fell out of favour with its bondholders, its net debt that would require off-market financing stood as high as 52% of German GDP as of the end of 2012.

Worryingly, the average maturity of France's government debt stock is just 7 years (as of the end of March 2013, according to France's Trésor[1]), compared to 15 years in the UK. The average maturity of as much as EUR 420bn (16% of Germany's GDP) of France's debt is 2 years and 11 days as of April 2013. Should France's economic difficulties translate into bondholders' worries, Germany would be forced to make even greater transfers to its neighbour.

We conclude that a one-off 6% GDP loss and 16% of GDP reduction in net foreign assets are a lower price to pay than underwriting France's economic difficulties in a few years down the road and long-term financing of public and private sector savings shortages in the debtor economies.

Slide 6 Table 5 – France inside or outside of the EMU?

France EMU exit

There is a roughly 20 percentage point differential in national unit-labor cost between France and Germany. The main reason has to be found in the way the French welfare system is financed that is by increasing public debt and taxing labour. The effective tax rates on labour and capital (calculated as receipts over the base) in France are each among the highest in OECD countries, while consumption is taxed (including VAT and excise tax) at or below the European average (arithmetic or weighted by the GDP of each country), which is 22 percent and 19.7 percent respectively.

As a result of this heavy taxation of labour (through employers and employees social security contributions and other forms of taxation), the social costs of labour borne by French employers are among the highest in the euro zone while French households enjoy lower tax rates on consumption and personal incomes. High payroll taxes and heavy labour-market regulation make it difficult – or at least prohibitively expensive – for firms to increase/reduce their workforce when business conditions improve/worsen. France's "tax wedge" (income

[1] http://www.aft.gouv.fr/rubriques/duree-de-vie-moyenne_166.html

taxes plus employee and employer social-security contributions minus cash transfers as a percentage of total labor costs) was at least 15 percentage points above the OECD average at every level of household income (OECD, 2012).

This emphasis on taxing labour maintains the political and social delusion of costless welfare according to which welfare is financed by companies *as opposed to* citizens. Having long maintained the illusion of getting something for nothing, these two expedients – relentless government borrowing and payroll taxes (social security contributions payable by employers) – have now undermined, respectively, the public finances and competitiveness. The delusion that taxing companies is a painless way of financing welfare and public services is now laid bare: Households and especially the young and older workers are faced with chronic high unemployment. Youth unemployment has recently reached 22.1% (April 2013, World Bank WDI) and joblessness among those above the age of 49 is now at 7.4% (March 2013, INSEE)

The damaging effects of this method of financing costly welfare/public services is aggravated by the excessive state regulation of the labour market and distorting state interference in product and service markets. Services remain more regulated in France than in most other OECD countries, notably in transport, professional services, and retail trade. The counterpart tends to be higher prices (for households and enterprises), owing to lower productivity or higher rents. By raising the purchasing power of households, deregulation of services would also support labour market reforms.

In the past decade France has faced a sharp loss of global export market share. This loss of exports has been accompanied by low profit margins of enterprises, which constrain their capacity to invest, innovate and create jobs. Given this current account deficit, an exit from the euro – whether voluntarily or forced – would mean that France's currency would depreciate relative the euro.

The French debt crisis might initially deepen as interest payments costs on the French debt would likely increase. Until the autumn of 2011 interest rates on French and German government bonds tended to move together and be quite close (figure 1).

Slide 7 -Figure 1 – French and German 10 years Government bonds yields

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French 10Y bond yields would be pressured higher upon exit due to the market asking for risk premia for inflation, currency depreciation and default. However, as central bank balance sheet expansion to purchase French government debt is the natural monetary policy support in case of France's EMU exit, the market impact is likely to be contained. French bond yields may tighten further in expectation of Bank of France participation in the bond market.

For France a credible fiscal-monetary effort at stimulating credit demand, made possible by the euro exit would be preferable than being forced into precipitate action as the Eurozone crisis deepened further and fiscal and monetary policy in effect became a part of a single public sector budget constraint.

The return to growth is the key to investor confidence, mainly because the fact of restored growth will underpin the credibility of sound macroeconomic and structural reform policies. By creating in this way the basis for confidence, it would be easier to overcome the financing problem resulting from a Euro exit. This problem arises from the devaluation (for sure) and (possibly) the redenomination of existing debt contracts into a new currency.

As pointed out by Roger Bootle (2012: 67): "an analysis of past sovereign defaults shows that a combination of debt reduction and devaluation has often provided a strong foundation upon which governments can re-establish the credibility of their fiscal policy and re-enter international capital markets surprisingly soon after a default." Historically as well there is "little historical evidence that default had led to significant denial of access to external financing." (Aggarwal and Granville, 2003: 3).

In these circumstances, any initial capital flight would be controllable through central bank balance sheet expansion and the commitment to fiscal-monetary coordination. And the risk of redenomination priced into bond prices might quickly become perceived as a source of greater value in French sovereign debt. It follows that the disruption to commercial and financial activity from any modification of debt contracts might not be so severe. The main problem instead would be the banking system, which would be insolvent as a result of its bond holdings; but here again as long as the French central bank is ready to step in quickly through provision of liquidity and overt monetary financing, panic could be avoided.

Fiscal Transfers game continues

Fiscal adjustment could possibly be delayed for long enough to trigger an eventual sovereign debt crisis. Indeed, as things stand, France would prefer to have its lack of competitiveness cushioned by transfers from surplus countries rather than pursue “internal devaluation”.

The problem is that such transfers will no longer be painless (in the sense of being an alternative to internal devaluation) – as was the case in the years before the 2008 financial crash when such transfers (that is, the financing of current account deficits) took the form of cross-border private sector lending to governments and, especially, to banks which in many cases lent the money to borrowers offering real estate as collateral. Since the credit bubble burst in 2008, these private financial flows have been replaced by state budget transfers and, therefore, ballooning budget deficits and implicit liabilities of peripheral countries in the ECB Target 2 (Trans-European Automated Real-time Gross settlement Express Transfer system).

This reality of extraordinary transfers of taxpayers’ money of one Eurozone country to other Eurozone countries is equivalent to political dynamite. For such transfers to be politically acceptable, they are bound to be made conditional on strict budgetary discipline and structural measures aimed at longer-term sustainability through “internal devaluation”. But even if this kind of conditionality were respected in a “Rules-Based Transfer Union”, it is by no means certain that taxpayers-voters in creditor countries like Germany would for ever be reconciled to such transfers, creating the risk of an anti-European backlash in Germany.

The best that the Eurozone debtor countries can hope for is not the political control of the ECB that French officials dream of, but rather ECB purchases of short-term government bonds (“Outright Monetary Transactions”) which, if they happen at all, will be subject to the same tough fiscal conditions enshrined in IMF programmes as apply to transfers from the ESM.

The outlook is therefore one of relentless fiscal tightening and demand repression, combined with broken transmission of monetary policy, lasting several years – resulting in shrinking or, at best, stagnating output and living standards. This has already caused anti-European and, increasingly, specifically anti-German backlashes in these countries’ domestic politics and this problem will become increasingly severe as per Feldstein (2013).

In or out of the euro, France will have to implement a “supply-side shock”, as recommended in a report on France’s competitiveness problem published on 5th November 2012 by Louis Gallois, a leading – and left-leaning – French industrialist. A reduction of taxes on labour - so called ’fiscal devaluation’ - would have the same effect as a reduction in wages by reduce unit labour costs. However, the immediate effect of such a program would be a weaker domestic demand and slower economic growth. To compensate for this movement and to maintain fiscal sustainability, the government would need to respond to external demand by a depreciation of the currency (not possible inside the euro) and, in an environment where in May 2013 consumer confidence was at its lowest since 2008 (INSEE)[2], France needs to encourage domestic demand initially via fiscal-monetary coordination in the form of overt monetary financing at a time of total economy deleveraging, while working at improving competitiveness and putting its preferred model of generous welfare and high quality public services onto a sound and sustainable footing. Put another way, the required supply side shock will only succeed if it appears credible both to the French public and to financial markets. And such deep reform policies will not be credible unless they are undertaken in an environment that allows from the outset some monetary and fiscal flexibility to support aggregate demand and in a context of decent economic growth. Neither of those two conditions for credibility – i.e. flexibility and growth – can be met in the present straitjacket of the “rules-bound transfer union” that is the current Eurozone.

The cost of internal devaluation within this straitjacket as opposed to external devaluation has been assessed by Weisbrot and Ray (2011) with reference to the experience of Latvia. The ‘internal devaluation’ for Latvia had dramatic social and economic costs especially in terms of unemployment (officially up from 5.3 percent at the end of 2007 to 20.1 percent at peak in early 2010 mainly because of the dramatic recession). Real effective exchange rate only declined by 7 percent following Latvia’s adjustment (Carton and Herve, 2012) while the lat in REER terms was more than 20% overvalued at the outset of the crisis suggest (IMF, 2009 Latvia Programme Review estimates). Moreover Latvia’s internal devaluation experience was misguided given that the foreign debt was largely in the private sector and that competitiveness could not be restored by public sector consolidation (Becker, 2009).

By compressing output, internal devaluation causes public debt ratios to deteriorate further, leading to increased yields and, ultimately, questions about the sustainability of the public debt path. Despite enjoying benign conditions in debt capital markets up to the time of writing, France clearly faces this risk – that is, of investors asking how France will grow its way out of the crisis when demand in Europe is flat and French goods are becoming ever less

[2] http://www.insee.fr/en/themes/info-rapide.asp?id=20&date=20130528

competitively priced in export markets. Indeed, the facility with which France was and is still able to borrow had the effect of loosening the budget constraints and therefore to postpone structural reforms leaving the country much more vulnerable to a change in market conditions

If the current snail's pace of reforms persists, we estimate the following explosive trajectory for France's public debt to GDP ratio to prevail (figure 2):

Slide 8 - Figure 2 – Projections of France's public debt to GDP ratio, 2013-2032. [3]

Conclusion

The cost of a German EMU exit we estimate (6% of GDP and 16% of GDP equivalent of net foreign assets held by the Bundesbank) is more manageable than financing the debtors' private and public sector dissaving at 2-4% of German GDP each year for an indefinite period of time.

The French economy requires deep structural reforms to boost competitiveness; but such reforms seem impossible while France remains in the straitjacket of the rules-bound transfer union that is the current Eurozone. High outstanding sovereign debt coupled with zero or negative economic growth pose a real challenge to the French economy saved for now only by the relatively low government bond yield but this is subject to market swings. An unacceptably large proportion of the French workforce is trapped in long-term unemployment with the most affected part of the population being the young and older workers suffering from long term unemployment because of the adverse incentives brought about by a social safety net financed by taxing labour.

[3] Standard debt-accumulation equation used. IMF WEO 2013 assumptions adjusted by taking into account slow progress on structural reforms i.e. the current pace of debt accumulation is continued. No debt monetisation assumed.