Moving Beyond the Trade - Macro (- Finance) Divide

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Towards Sustainable Growth, CompNet Round Table Frankfurt
June 25 2015

Early expeditions

Current Account Rebalancing: the traditional view

- Start with Obstfeld and Rogoff 2000 (summing up the conventional wisdom)

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- Since then...

Income effects

- Theory IRBC and NOEM
  - Income/wealth effects as key element of the international transmission mechanism, incomplete vs complete markets. Corsetti Dedola Leduc Restud and JME 2008 and many others.
- Empirics. Demand adjustment via composition effects in the consumption basket Bems and Di Giovanni on Latvia, Rebelo & coauthor
  - feedback on sectoral composition of employment.
- MACRO

Elasticities

- High and low, short and long-run
  - extensive margins
- but new directions: investment in distribution capacity/supply chain.
  - Corsetti-Dedola; Crucini and Scott: investment in vertical interactions.
- SPLIT Trade and macro

Re-allocation

- Y_H Y_N not constant, rebalancing requires shifts of resources from N to H
- Intersectoral Labor? so far little
- Firms dynamics? much more
  - Eaton vs Corsetti Martin and Pesenti
  - DSGE model (Pappada' etc.)

Key policy implications

- Exchange rate movements much less dramatic => empirical evidence
- Non-price competitiveness. Entry costs.
- Re-allocation requires resources, complex in a financial crisis with collapse of domestic demand.

Mostly to TRADE

Finance

- Trade Credit
- Entry

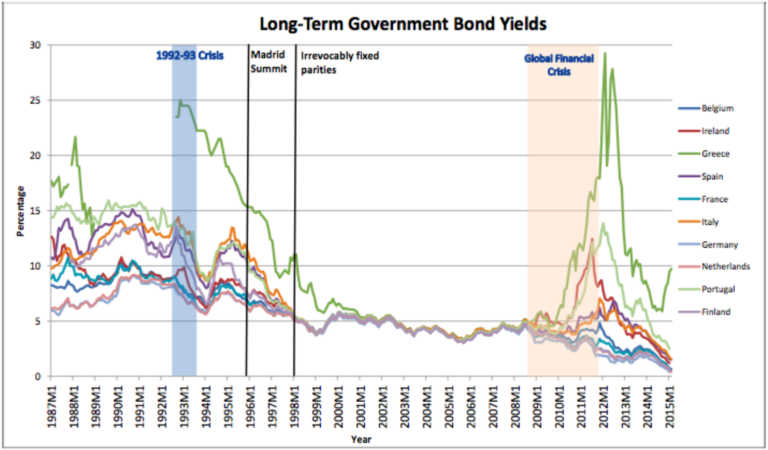
But also macro perpective

- International financial market=> risk => equilibrium pricing.
- Risk sharing and/of global value chain.

Stabilization policy

- Short-run stabilization and reforms
  - - e.g. Ghironi
- Beyond Competitive Devaluation:
  - Terms of trade externality in standard New-Keynesian models
  - Stabilization and comparative advantages. Bergin and Corsetti

Two-crises compared



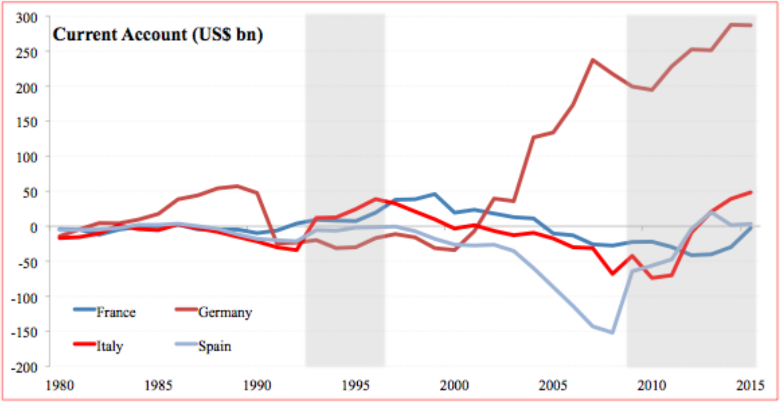
Source: IMF International Financial Statistics (updated May 2015)

The 1992-93 ERM crisis: adjustment easier than today

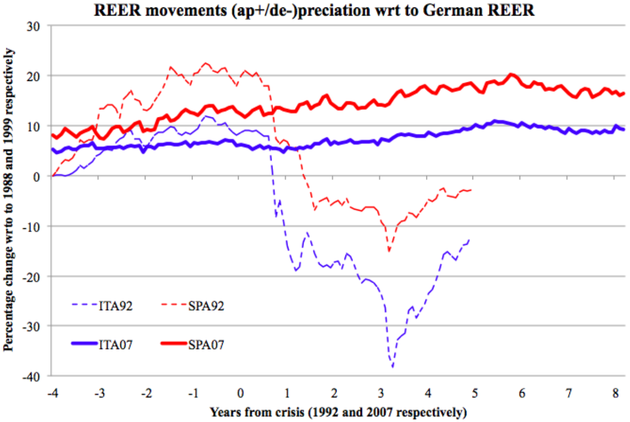
More favorable context, more instruments to absorb shocks

1. Germany in a boom and run external deficits (today, largest surplus)
2. Exchange rates could and did move, adjusting relative income and demand (today, mostly wages and employment)
3. Public debt denominated in domestic currency, devaluation led to up-front adjustment of debt price in international portfolio
4. Moderate national inflation helped budget consolidation and real wage rebalancing across sector

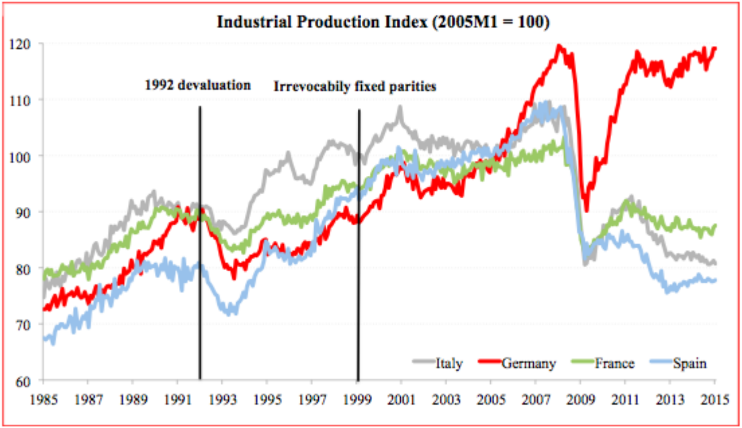
Current accounts then and now



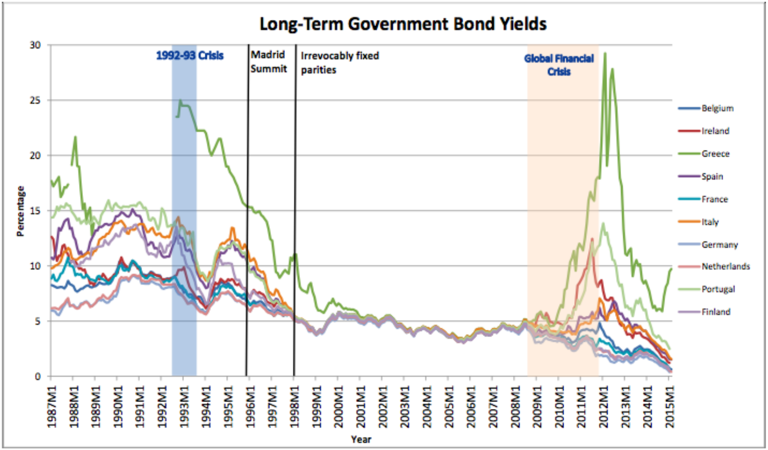
Bilateral real exchange rate with Germany, then and now (+ is appreciation)



Industrial production then and now



Yet crisis did not subside! — Financial turmoil through 1995



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A missing lesson

- Exchange rate and other instruments to absorb shocks reduce the scope for policy conflict.
- The Madrid Summit In December 1995: renewed political cohesion was possible on rebooting the euro project
- Surprising success in restoring calm in financial markets

The missing lesson and the euro

Lack of instruments at national level to absorb shocks:

1. raise the value of political cohesion and coordinated policy action
2. exacerbate policy conflict and generate "mistrust"

- In terms of the prisoner's dilemma

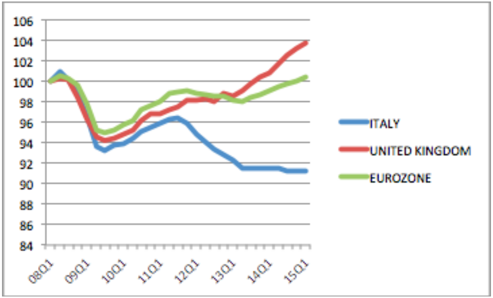
$$\begin{array}{cc} & \textit{Player } 2: \\ \textit{Player } 1: & \begin{array}{cc} C, C & C, C+\alpha_2 \\ C+\alpha_1, C & C-\beta_1, C-\beta_2 \end{array} \end{array}$$

the Euro raises the correlation between α (incentive to deviate) and β (cost of non-cooperation) (Hamid Sabourian).

- E.g. resources/liquidity provision against reforms.

The cost of Non-Europe: delay in setting up OMTs let "sovereign-risk-genie" out of the bottle

Quarterly GDP IT UK, 2008Q1=100



"A common misconception about the European Union – and the euro area – is that they are economic unions without an underlying political union. This reflects a deep misunderstanding of what **economic union means***: it is* **by nature political***. [...]*
If our union has proved more resilient over the past years than many thought, it is only because those who doubted it misjudged this political dimension. They underestimated the political underpinnings of our union, the ties between its members, and the amount of political capital that has been invested in it.
Yet it is clear that, for all its resilience, our union is still incomplete."

Stability and Prosperity in Monetary Union, Speech by Mario Draghi, President of the European Central Bank, at the University of Helsinki, Helsinki, 27 November 2014

Introduction

- From Draghi's quote, new insight on a well known political thesis
    1. The euro was launched lacking the institutions required for its sustainability.
    2. Member states were expected to agree on institutional development over time:
    - in light of past history, possibly under pressure of crises (overcome political resistance at country level) — this crisis is obviously more than Jean Monnet bargained for.

We are now learning what "incomplete monetary unions" mean.

Main idea: a systemic crisis

Crisis typically read in the light of the (large) literature on imperfect policy credibility at national level, at the root of

1. weak fundamentals
2. vulnerability to currency and debt crises (including "contagion effects")

Same problem arise in a monetary union without sufficient institutional development.
Imperfect credibility of euro-area institutions and policymaking

1. makes room for belief-driven speculative behavior
2. generates destabilizing systemic (policy) shocks

This is the area where we can do better.

and the key questions/source of conflict for Europe are...

...

- Energy
- Defence
- Migration EX WITHIN
- Competitiveness, efficiency (systemic) and productivity growth
  - economic geography: D and Eastern Euro, Ireland UK US, Southern Europe
- Best reconciled in a single market/single currency area?
  - governance,
  - welfare state, social protection
  - single European Firm and European worker (pensions).
- and more....