Public Affairs 854
Macroeconomic Policy and International Financial Regulation
Lecture 14
12/11/2014

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La Follette School of Public Affairs
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Outline

• Emerging Market Issues
• Europe
• The Slow Recovery
Emerging Market Issues

Emerging and retreating
Currencies against the dollar
September 1st 2013=100

1

Brazilian real
Indian rupee
Indonesian rupiah
South African rand
Turkish lira
Russian rouble

GDP and consumer prices
% increase on a year earlier

1

GDP, 2014*
Consumer prices, Oct 2014 or latest

Current-account balance, 2014*, % of GDP

Sources: Thomson Reuters; Haver Analytics; Economist Intelligence Unit; The Economist

* Forecast

Economist (Nov. 8, 2014).
And Capital Flows Respond

Chart 21
Total Non-Resident Portfolio Flows
$ billion; estimates as of October 27, 2014
Not All EM Countries Equally Vulnerable

Figure 1.4.1. Distribution of Exchange Rate Regimes in Emerging Markets, 1980–2011 (Percent)

Source: IMF staff calculations.

Figure 1.4.2. Predicted Crisis Probability in Emerging Markets, 1980–2011

Source: IMF staff calculations.
Note: Predicted probabilities are obtained from a probit model of crisis likelihood evaluated at mean values of control variables. See Ghosh, Ostry, and Qureshi (2014) for details of the control variables included in each crisis likelihood estimation and for definitions of crisis variables.

Source: IMF, WEO, April 2014, Chapter 1
References

• IMF, *World Economic Outlook*
• IMF, *Global Financial Stability Report*
• IMF, *G20 Surveillance Notes*
• Institute for International Finance, various reports
  [https://www.iif.com/analysis](https://www.iif.com/analysis)
• Bank for International Settlements (BIS) *Quarterly Review*
  [http://www.bis.org/publ/qtrpdf/r_qt1412.htm](http://www.bis.org/publ/qtrpdf/r_qt1412.htm)
• PIIE
Europe
The Euro Zone – Another Recession?

Source: OECD, Economic Outlook, November 2014
What’s Wrong with the Euro Zone?

D. Output gap

- United States
- Japan
- Euro area
- United Kingdom
Not All of the Euro Zone Suffers

Table 2.2. Selected European Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment

*(Annual percent change unless noted otherwise)*

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How Did They Get There?

• The eurozone is not an optimal currency area
• Fiscal profligacy (sometimes)
• The (seeming) disappearance . . . and reappearance of risk
Asymmetric Supply Shocks

Growing trade integration (a la Frankel and Rose) was not sufficient to overcome this asymmetry.

Enhanced factor mobility via reductions in labor segmentation was also insufficient.

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Sources: Authors's calculations, and Bayoumi and Eichengreen (1994).
Fiscal Profligacy...sometimes

Figure 4
Debt and Deficits Relative to GDP

2007-2009
Debt-to-GDP Ratio

2009-2011 (p)
Debt-to-GDP Ratio

NOTE: Left panel: In most countries, deficit-to-GDP and debt-to-GDP ratios increased during the crisis. Right panel: More recently deficit-to-GDP ratios have fallen, but debt-to-GDP ratios continue to rise. 2011 data are projected (p). Adapted from Contessi (2012).

Contingent Liabilities: The Disappearance and Reappearance of Risk

Source: ECB
The Self-Reinforcing Crisis

Indebted Private and Public Sectors

Household, Nonfinancial, Gov't debt to GDP, 2010Q4

Austerity Is Counterproductive

Figure 10. Change in Government Spending and Change in GDP in Euro-Area Countries, 2008Q1–2011Q1

The Medium Run Adjustment in Monetary Union

Adjustment under Fixed Exchange Rates

The aggregate supply curve shifts down over time, leading to a decrease in the price level, to a real depreciation, and to an increase in output. The process ends when output has returned to its natural level.
And Competitiveness Problems Persist

C. Structural adjustment underway: unit labour cost adjustment in the euro area

Source: European Commission (Winter 2013 Forecast), ECB calculations.
Note: Data for 2012 are forecast. Unit labour costs data are calculated on the basis of full-time equivalent measures of total employment and employees for DE, ES, FR and IT.

Source: Peter Praet, Member of the Executive Board of the European Central Bank, at the afternoon session “The challenges ahead Apr 17, 2013
ECB Intervention
ECB Drives Down Sovereign Yields

Ten year govt bond yields, %

Source: ECB
Capital Market Fragmentation

Source: IMF, World Economic Outlook (October 2014), Table 2.3
Diverging Inflation, Unemployment

Source: IMF, WEO, October 2014, Figure 2.3
One Solution Foregone Thus Far

Source: BLS and ECB via FRED. PCE deflator for US, HICP for Euro area
The Slow Recovery
A Large, Persistent Output Gap

Source: BEA, CBO August 2014
Financial vs. Normal Recessions

Figure 3: Conditional Paths, Continuous excess credit treatment

Real GDP per capita (% deviation by year)

Normal recessions (conditional):
+ Excess credit
+ 1,2,3 %GDP/year

Financial recessions (conditional):
+ Excess credit =
+ 1,2,3 %GDP/year

Source: Jorda, Schularick, Taylor, When Credit Strikes Back, NBER Working Papers No. 17621 (Nov. 2011)
Figure 4: All Conditional Paths: Financial v. Normal Recessions

Cumulative Change From the Start of the Recession

- Real GDP per capita
- Real Investment per capita
- CPI Prices
- Real Lending per capita
- Govt. Short-term Interest Rates
- Govt. Long-term Interest Rates
- Current Account to GDP Ratio
How Does the US Fit In?

(b) Based on conditional paths, continuous excess credit treatment

Real GDP per capita (% deviation by year)

- Normal recessions (+ 95% confidence interval)
- USA, 2007-11 and 2012e
- Predicted range:
  - Financial crisis + exc cred +0.50% (USA, banks)
  - Financial crisis + exc cred +2.75% (USA, banks & shadow)

Source: Jorda, Schularick, Taylor, When Credit Strikes Back, NBER Working Papers No. 17621 (Nov. 2011)
Other Factors

• Relatively small size of “the stimulus”
• Sequester in 2013
• Zero lower bound
• Foreign shocks
  - Europe in 2011
  - Libya/oil
Growth and Oil Prices

GDP growth q/q SAAR [left scale]

Arab Spring/Libya

Log oil price [right scale]
Growth and Policy Uncertainty

GDP growth q/q SAAR [left scale]
Policy uncertainty [right scale]

D(LOG(GDP09))*4
POLICYUNCERTAINTY
Investment and Uncertainty

Business fixed investment/GDP [left scale]

Policy uncertainty [right scale]

INV_NONRES/GDP  POLICYUNCERTAINTY