

# European Economy under New Leadership

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# 1. Short-term Outlook

## 1. Short-term outlook:

In 2020, growth rate of the Euro area will be 1.3% (IMF World Economic Outlook, January), while the CPI inflation rate will be below 1.5% with the inflation expectation standing at 1.3%.

There are a number of downside risks on forecast:

- Negative impact from the outbreak of coronavirus(Figure 1).
- Negative spillover from the “immersion into managed trade” with the China’s secret annex of product-to-product commitment (Hufbauer(2020)), as a result of the US-China trade negotiation and the hegemonic war in high technology between the US and China(Figure 2).

# 1. Short-term Outlook

- Uncertainty about the US-EU trade negotiations(Airbus-Boeing issue, tariffs on automobile, digital tax and the difficulty to conclude the TTIP with respect to data privacy).
- Remaining risks of failure to finalize the Brexit negotiations by the end of 2020: additionally, there remains uncertainty on the move by Scotland and North Ireland toward independence(Figure 3).
- Structural challenges facing automobile industry(notably in Germany) in the face of new environment regulations and the transition to EV cars(Figure 4).

# 1. Short-term Outlook

2. Monetary policy continues to be expansionary.

-Possible introduction of “Green QE”(=purchase of the green bonds and prohibition to purchase the brown assets) coupled with the prudential policy to include the disclosure of financial risks and the stress test relating to climate changes and the likely amendment of Basel III, given the risks of the next crisis of “green swan” and 17 trillion dollar of stranded assets due to the limited carbon budget (Bolton et al.(2020))(Figure 5).

-For new ECB president Lagarde, “Climate policy is mission critical” in contrast to Fed Chairman Powell’s view: “Climate change is not a near term threat”: Climate change issue is politically controversial with the implication for eroding operational independence of central bank:

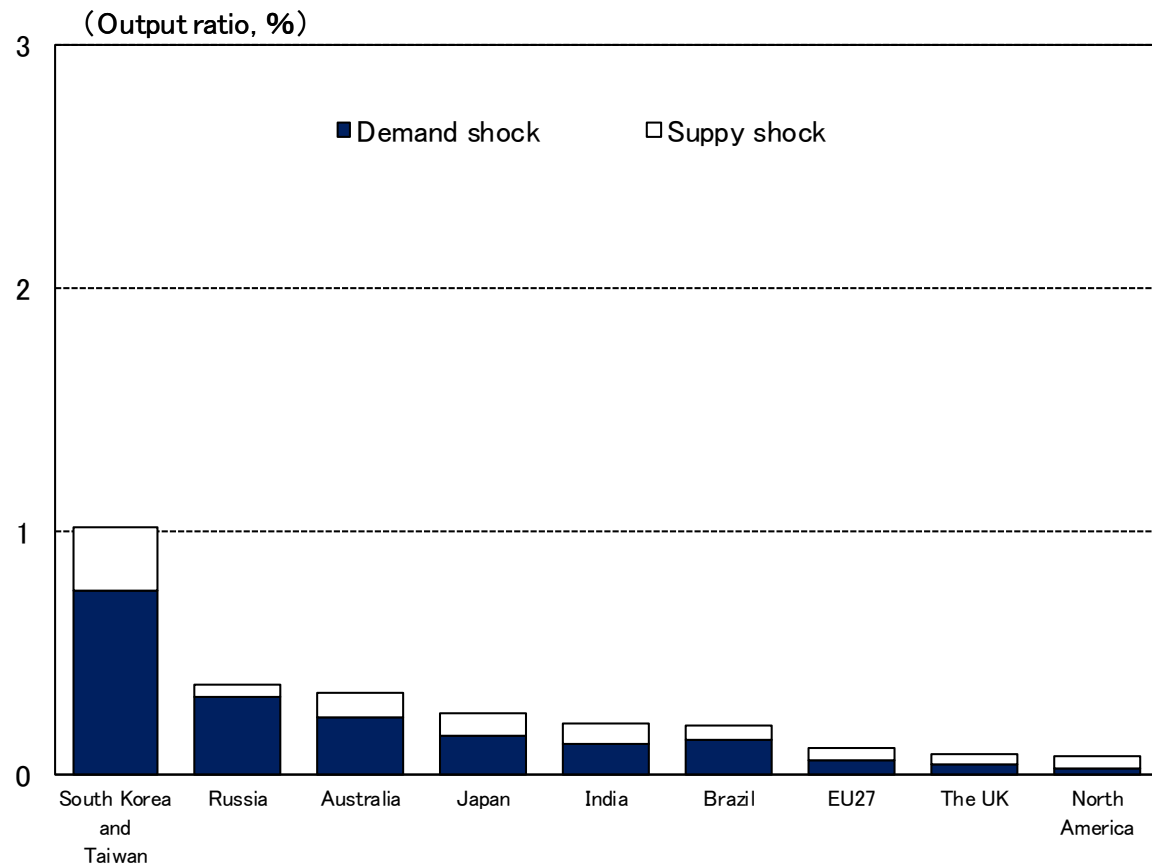
# 1. Short-term Outlook

- For the ECB, the room for further cut in policy interest rates will be limited, given the risk of the reversal rate exemplified by the Riksbank's withdrawal from negative interest rate policy.
- Yet, there is a risk of the “Japanification-lit” due to the low natural interest rate in Euro Area(Figure 6).
- The global decline of nominal and real long-term rates will persist in the medium- and long-term (Shmelzing (2020)). Even the case of the US zero nominal long-term interest rates is not excluded over the future (J.P. Morgan(2020))

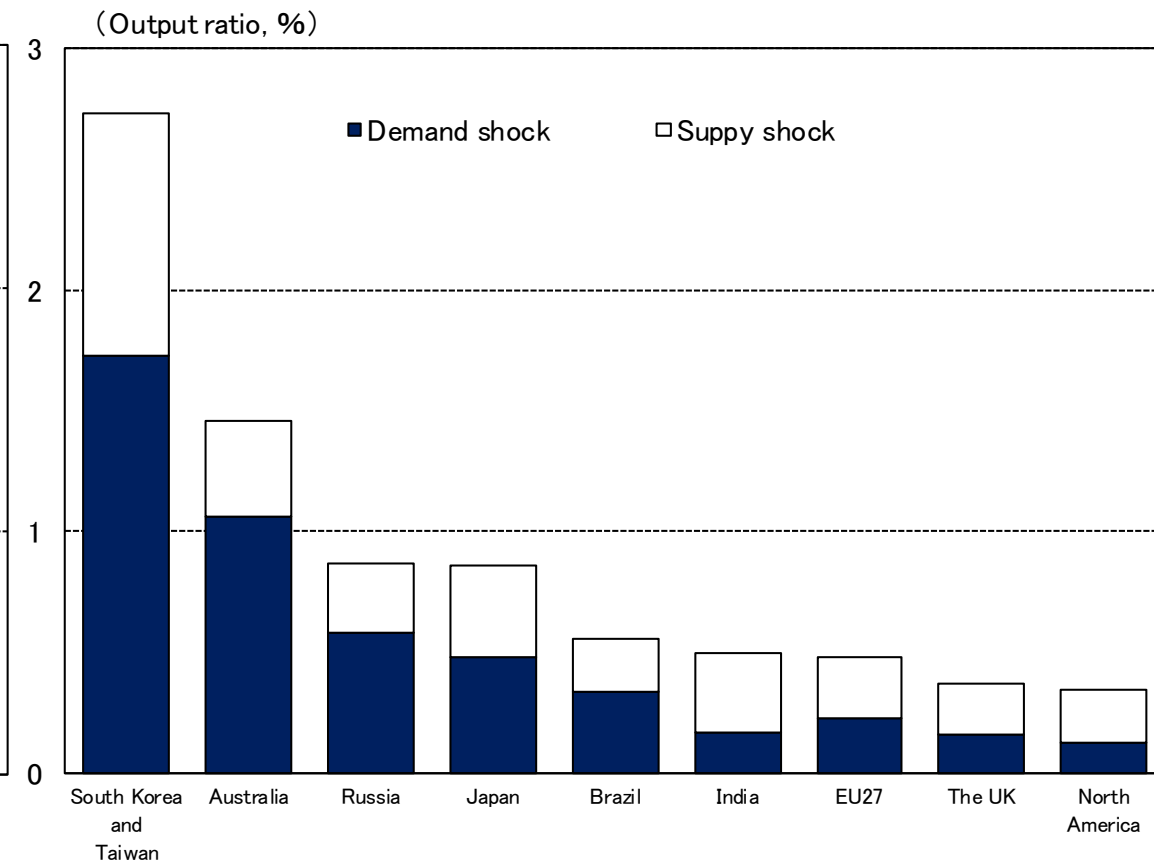
3. Fiscal space is limited: even in Germany the constitutional constraints on structural budget deficit limit the fiscal action (Pisani-Ferry(2019)). The role of automatic stabilizer seems important in advanced economies (Iwata, Kastrop, Leowald and Veron(2017)).

# Figure 1. Impact of Outbreak of Coronavirus on Global Production

【2003】



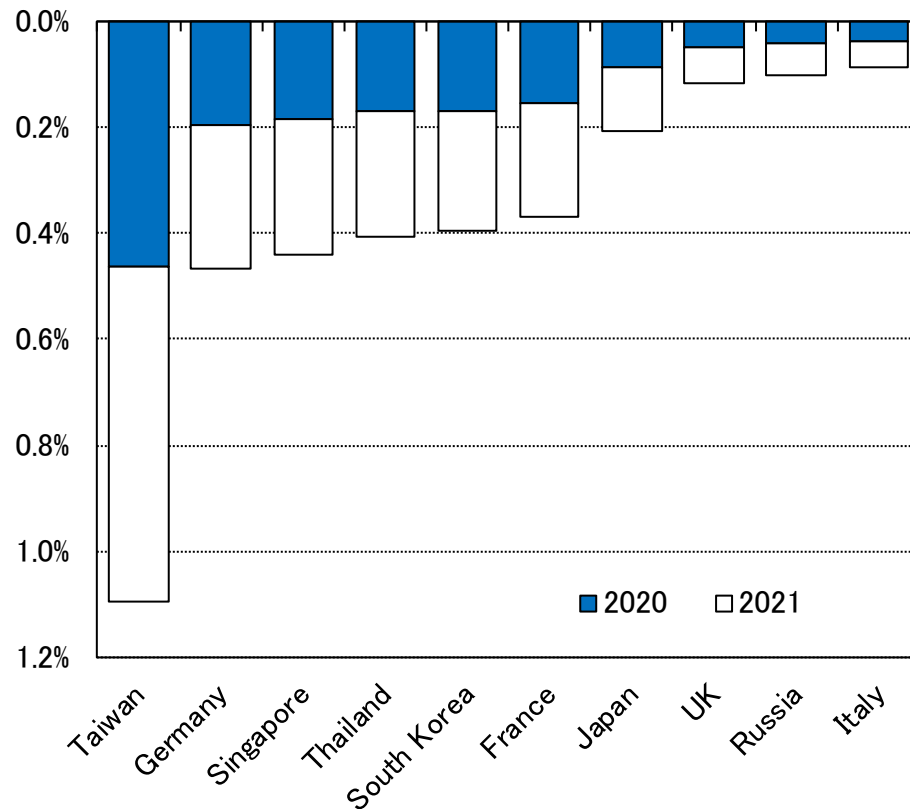
【2014】



Note: Demand/supply shock shows negative spillover effects on upstream/downstream industries under hypothetical 10% decrease shock in production of the Chinese manufacturing industries. Based on Leontief and Ghosh inverse matrices calculated from World Input-Output Database.

# Figure 2. Negative Spillover of the US-China Trade Negotiations

【The Impact on Export】



【 Major export items substituted by U.S. exports 】

Ranking	Germany	France	UK
1	Other aircraft (HS 8802)	Other aircraft (HS 8802)	Motor cars (HS 8703)
	▼\$6.1bn	▼\$8bn	▼\$2.2bn
2	Motor cars (HS 8703)	Turbo-jets and propellers (HS8411)	Medicaments (HS3004)
	▼\$5bn	▼\$0.4bn	▼\$0.15bn
3	Medical equipment (HS9018)	Medicaments (HS3004)	Turbo-jets and propellers (HS8411)
	▼\$0.6bn	▼\$0.1bn	▼\$0.11bn

Note1: The impact on export shows decreases in export to China substituted by U.S. exports. The vertical axis indicates the export decrease as a percentage of GDP.

Note2: In the left figure, the top 10 countries with the largest export to China are selected. Exports are based on items covered by the U.S.-China agreement.

Source: Comtrade, Haver Analytics.

# Figure 3. Divided United Kingdom

【Results of the 2019 UK election in Scotland】

Party	Policy	Seats
SNP	Independence	48 (+13)
CON	Remain	6 (▼7)
LD	Remain	4 (±0)
LAB	Remain	1 (▼6)

【Scottish Stance】

	2014 referendum	Jan. 2020 questionnaire
For independence	44.7%	52%
Opposed to independence	55.3%	48%

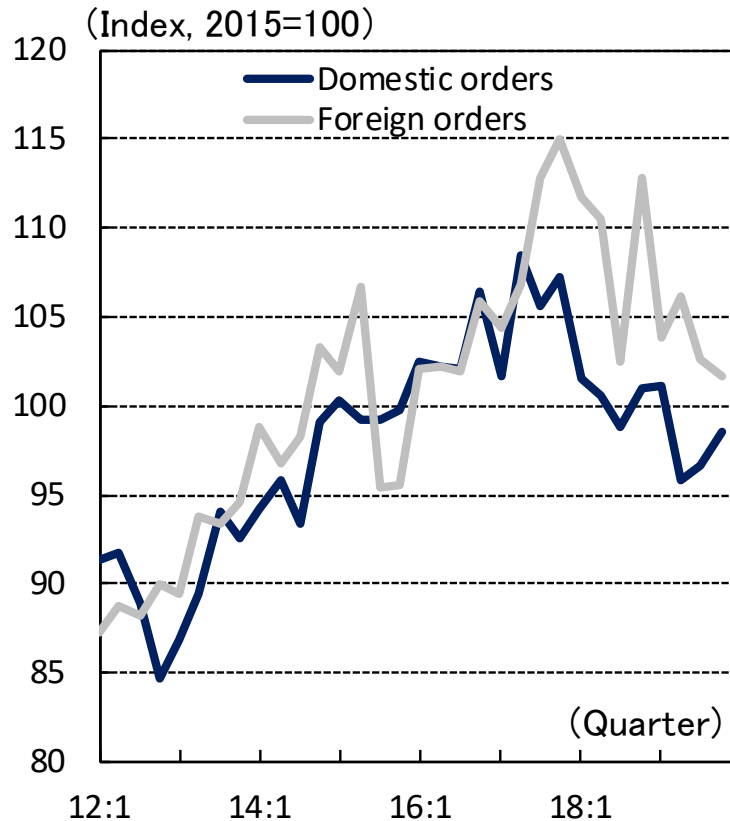
【 Results of the 2019 UK election in Northern Ireland 】

Party	Policy	Seats
DUP	Unite with the UK	8 (▼2)
Sinn Fein	Unite with Ireland	7 (±0)
SDLP	Unite with Ireland	2 (+2)
APNI	Neutral	1 (+1)



# Figure 4. New Orders of Automobile Industry

## 【New orders in German automobile industry】



Note: The latest is the forth quarter 2019, averaged in October and November 2019.

Source: Haver Analytics.

## 【Eurozone regulations on automobile industry】

	Detail
France	<ul style="list-style-type: none"> <li>The standard for CO2 emissions have been lowered to 110 g/km from January 2020.</li> </ul>
EU	<ul style="list-style-type: none"> <li>CO2 emissions will be regulated to 95 g/km from 2021.</li> <li>Manufacturer has to pay an excess emissions premium of €95 for each 1g/km of target exceedance for each car registered.</li> </ul>

## 【Eurozone automobile companies preparing for EV】

Company	Detail
Volkswagen	<ul style="list-style-type: none"> <li>33 billion euros to invest in electric vehicles over the next 5 years.</li> <li>To Invest 1 billion euros in battery manufacturing.</li> </ul>
PSA	<ul style="list-style-type: none"> <li>Partnered with Hon Hai to make electric cars</li> <li>Agreed to a merger of equals with FIAT in December 2019.</li> </ul>

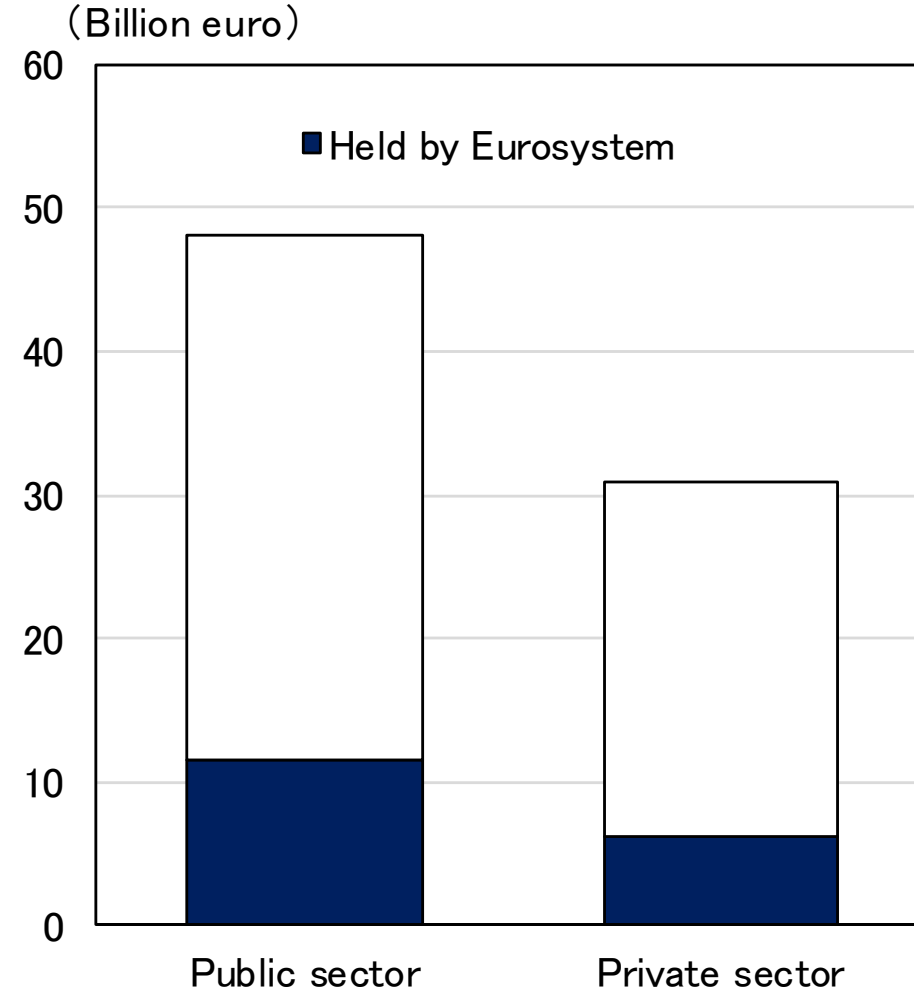
Source: IR materials from various companies, various news articles.<sup>9</sup>

# Figure 5. Climate Changes and Green QE

## 【Opinions from leading figures】

	Opinions
Lagarde (President of ECB)	<ul style="list-style-type: none"> <li>■ ECB's macro model should take into account green issues.</li> <li>■ The risks of climate change should be taken seriously when regulating eurozone banks.</li> </ul>
Villeroy de Galhau (Governor of the Bank of France)	<ul style="list-style-type: none"> <li>■ Central banks should deal with the stagflationary shocks induced by climate change.</li> <li>■ The risks of green issues have to be reflected when assessing collaterals.</li> </ul>
Weidmann (President of the Deutsche Bundesbank)	<ul style="list-style-type: none"> <li>■ Monetary policy should be targeted on inflation rate, not on a specific social objective.</li> <li>■ Massive purchases on a relatively shallow pool of green bonds could distort the market.</li> </ul>

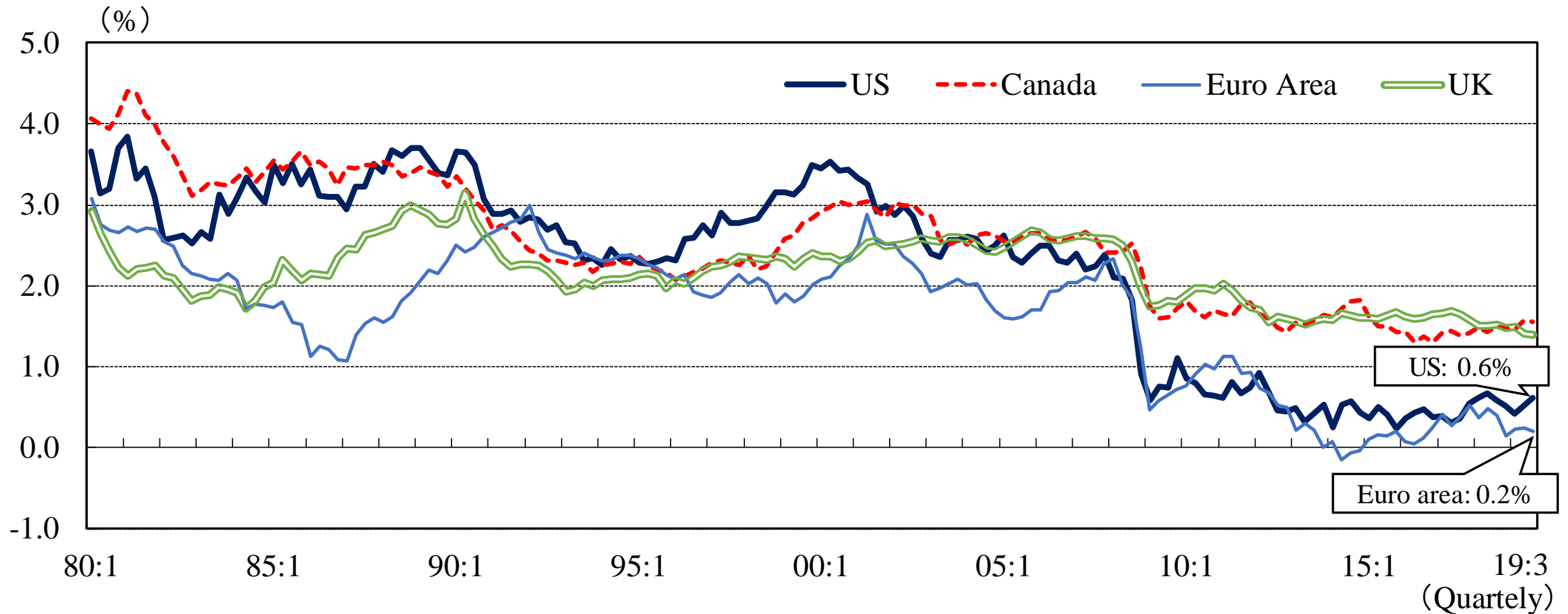
## 【 The volume of eligible green bonds 】



Note: As of November, 2018.

Source: ECB.

# Figure 6. The Natural Interest Rate in Main Countries



Source: Federal Reserve Bank of New York, Holston, Laubach, and Williams (2017)

## 2. Long-term Outlook

### 1. Long-term outlook

- Potential growth rate in the Euro Area will be about 1% over long-term: Germany will exceed Japan in economic size in 2050s (Japan Center for Economic Research(2019))(Figure 7).

- Labor force decline over the future is likely to be significant in the absence of massive immigration (Iwata, Maeda and Takano(2019)) (Figure 8).

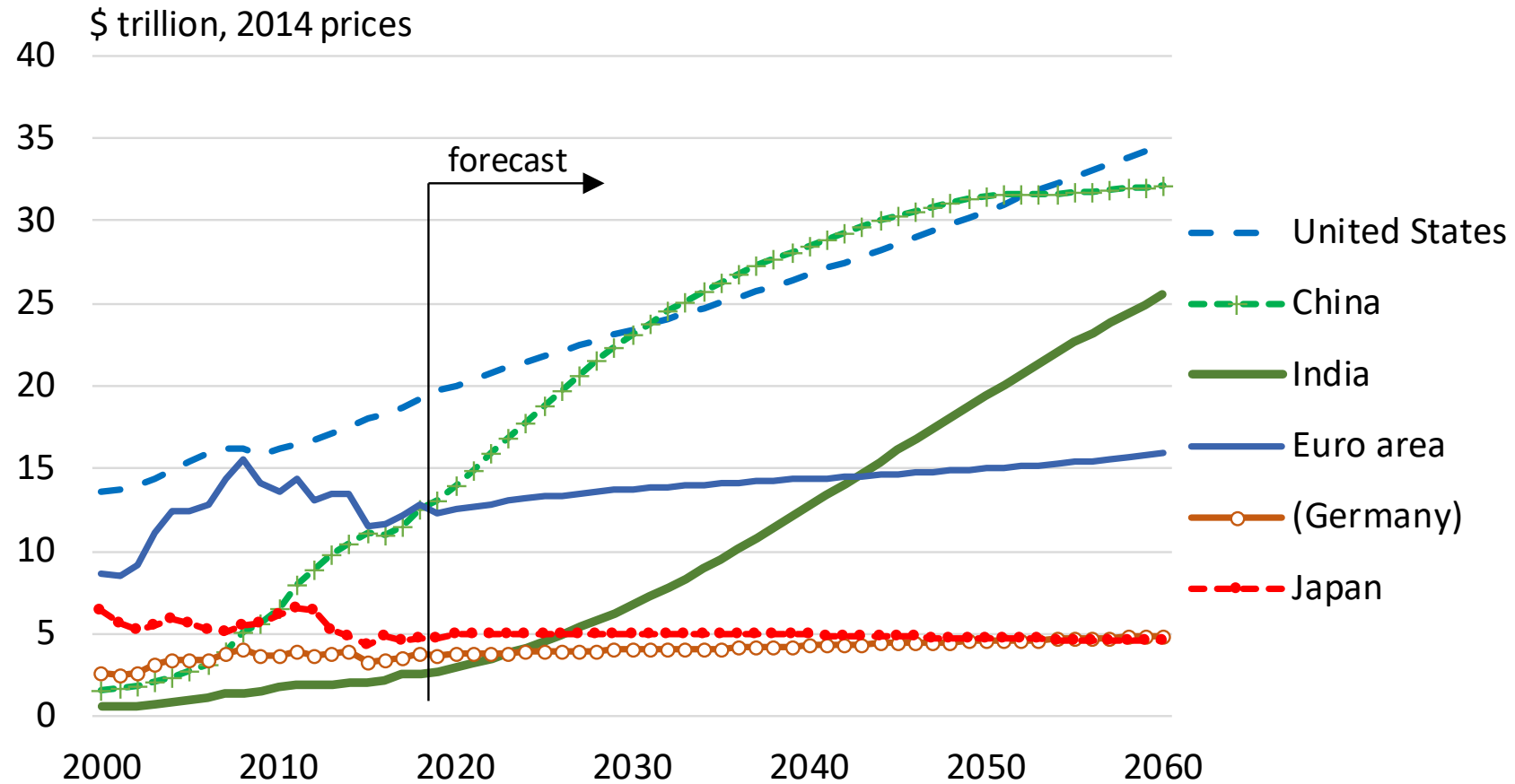
- Labor saving technological change will show remarkable convergence among advanced economies at slightly higher level in 2060 than the current one, reflecting the digital revolution process combined with the “Baumol’s disease”. China’s technological progress will gradually converge to the growth of advanced economies (Figure 9).

## 2. Long-term Outlook

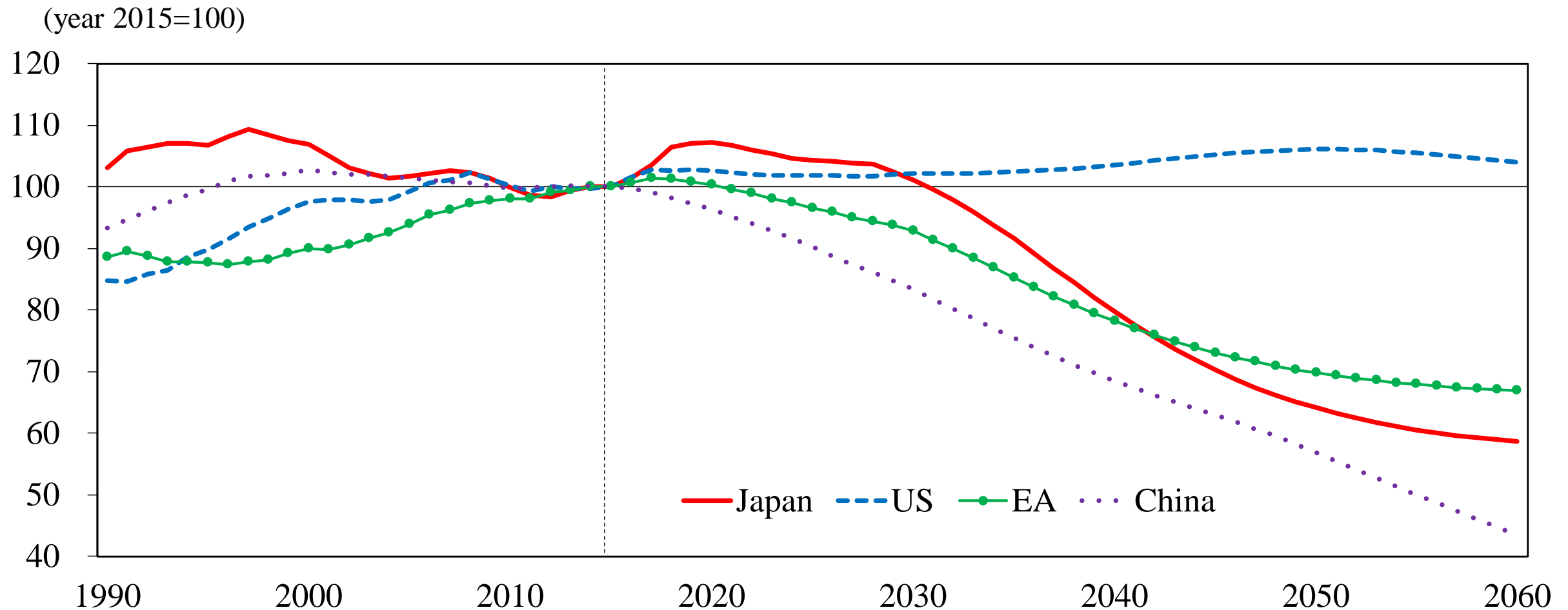
### 2. External imbalance

- Current account surplus in the Euro area will remain moderate in the long-term perspective, reflecting the relatively high net national saving ratio (Figure 10), although the current account surplus in Germany will remain large.
- Current account imbalance may be more serious within the Euro area than the global imbalance (Figure 11).
- Net foreign asset in the Euro area accumulates to reach about 100% of GDP in 2060 (Figure 12).

# Figure 7. World Economy in 2060

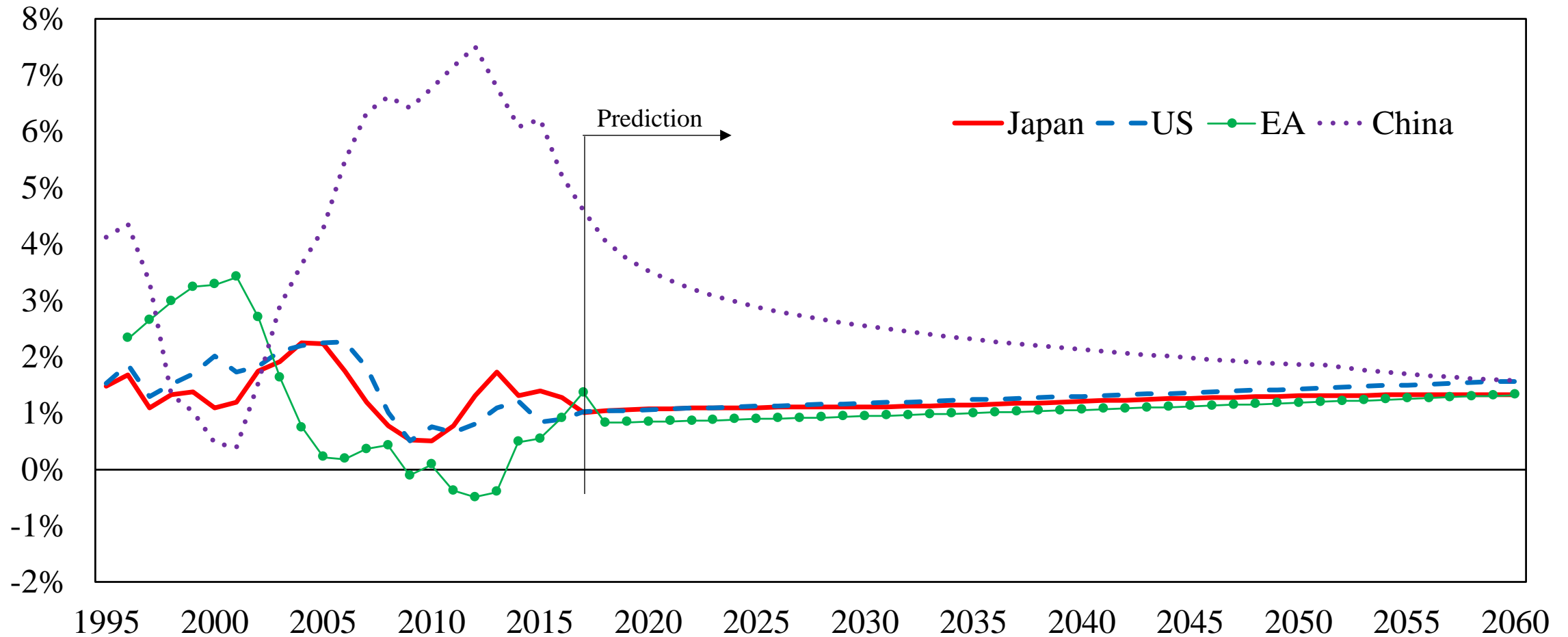


# Figure 8. Labor Force Development



Source: OECD Economic Outlook Database, Japan Center for Economic Research, Iwata, Maeda, and Takano (2019)

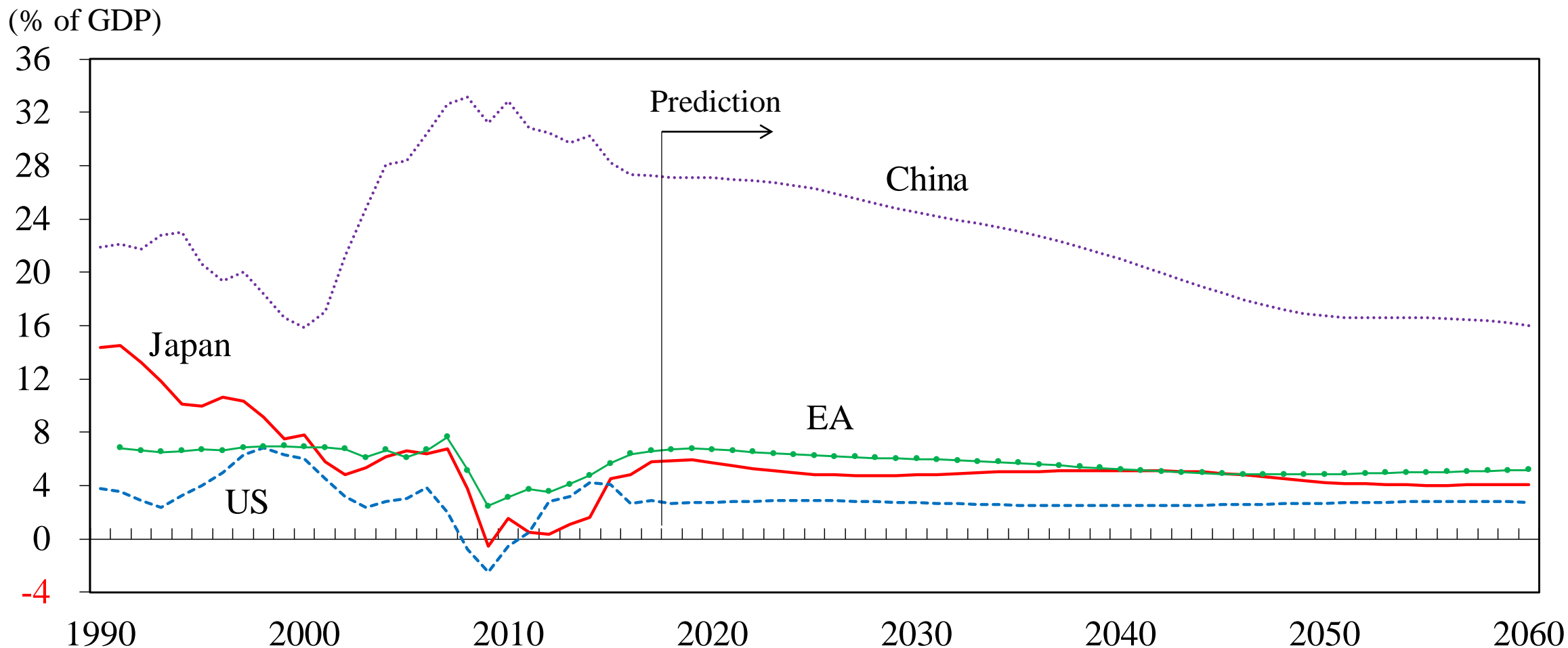
# Figure 9. Labor Saving Technological Progress



Source: Japan Center for Economic Research, Iwata, Maeda, and Takano (2019)

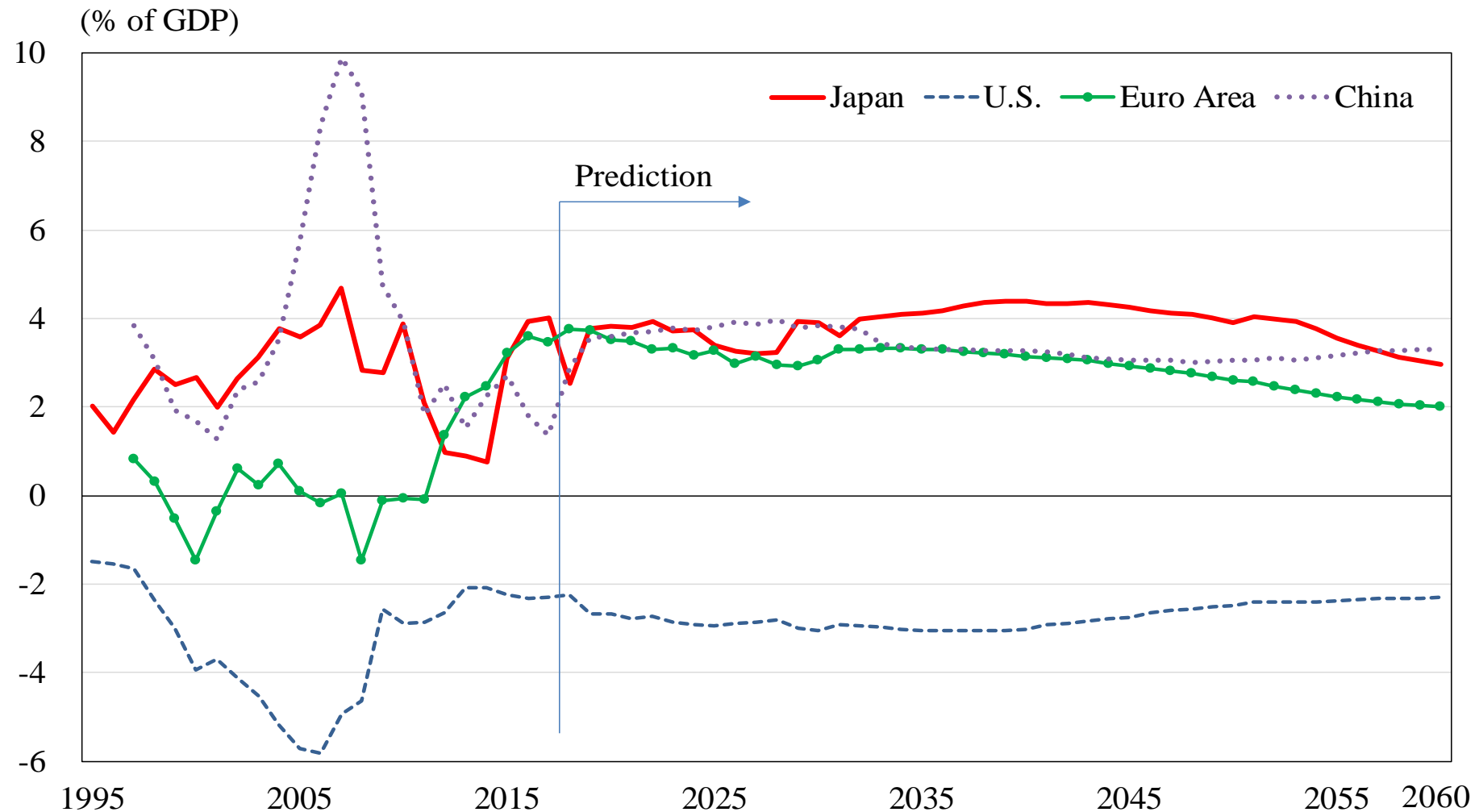


# Figure 10. Net National Saving Ratio in Main Countries



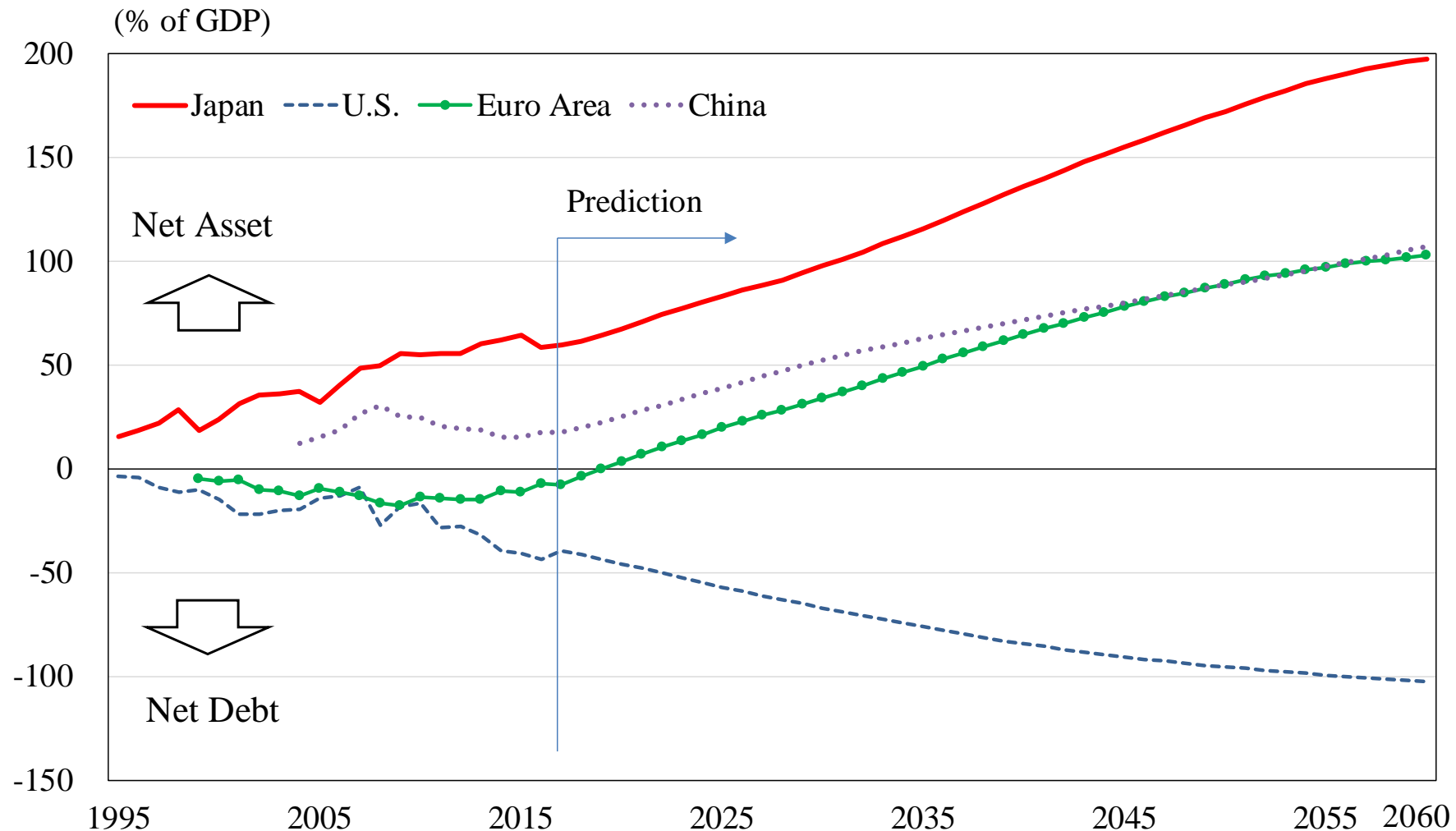
Source: OECD Economic Outlook Database, Japan Center for Economic Research, Iwata, Maeda, and Takano (2019)

# Figure 11. Prediction of Current Account Balance



Source: Japan Center for Economic Research, Iwata, Maeda, and Takano (2019)

# Figure 12. Prediction of Net Foreign Asset/Debt



Source: Japan Center for Economic Research, Iwata, Maeda, and Takano (2019)

### 3. Enlightenment: the European Project

1. Stiglitz(2016) noted that Europe has served as the source of Enlightenment to the global society and economy through implementing a number of European Projects.

-Europe's new leader, Ursula von der Leyen, has embarked on the "green initiative" and pledged to strengthen the competition policy equipped with the protection of privacy.

-Philippon(2019) observes the "Great Reversal", where the market is more competitive and free in Europe than in the US, due to the success of single market mechanism (which was launched in 1993) and the more independent competition policy authority from political interventions than the US.

### 3. Enlightenment: the European Project

2. I welcome the “Green Initiative” which consists of 1 trillion infrastructure investment in the coming decade and the use of carbon pricing (target of 100 euro per ton of CO<sub>2</sub> in 2030) combined with the introduction of carbon border adjustment tax (which may be taken up as serious WTO agenda).

3. Commissioner Margrethe Vestager in charge of competition policy has been assigned a new job in charge of digital economy as the EU vice-president.

-There is a question as to whether the promotion of IT industry in Europe is consistent with the goal of competition policy (It is unimaginable in Japan that the Minister of the METI is assigned a job as head of the Fair Trade Commission).

### 3. Enlightenment: the European Project

4. The EU provided a great enlightenment on the use of personal data to secure the right of portability and the right to be forgotten (the GDPR).

-The US lags behind the Europe, mainly due to the lack of legal arrangements on data privacy at the Federal level.

5. The EU can exercise the leadership role to reform the WTO in the area of state subsidy and the intellectual property as well as the reconstruction of the Appellate Body together with other countries including Japan.

-It was unfortunate that Japan did not participate in an Interim Appeal Arbitration Arrangement endorsed by 16 WTO members to rescue the paralysis of the WTO Appellate Body in January 2020, although Japan, the EU and the US made a joint statement to request China to conform to the WTO discipline on the state subsidy in December 2019.

## 4. More integration or More Fragmentation

### 1. Move toward integration

-In the process of dealing with the Greek crisis, the European Financial Stability Facility in 2010, the European Stability Mechanism in 2012 and the European Securities and Markets Authority in 2011 were established.

-Banking union: completing the banking union with a genuine deposit insurance scheme engaging in the crisis management after establishing the single supervisory authority in 2012 (which monitors about 6000 banks in eurozone) and the single resolution authority in 2014 (Veron(2019))

-Capital markets union: the move toward the CMU is too slow, partly due to the dominance of dollar in global finance and the lack of the banking union.

## 4. More integration or More Fragmentation

- ECB structure: Buiter(2019) noted that the ECB has a fatal flaw: the national central banks in euro area can go bankrupt, due to the lack of control over the central bank money by national central banks (which are similar to the currency board scheme). Additionally, the absence of single fiscal authority(=fiscal union) implies the shortage of fiscal backing of the ECB.
- Fiscal union: still far away
- On the Eurosystem's retail payment a new strategy of a Pan-Europe vision as a solution for point-of-sales and online payments was announced in November 2019, based on the retail payments at the location of the purchase or interaction(POI) after establishing the Single Euro Payment Area(SEPA) and the Target Instant Payment Settlement (TIPS).



## 4. More integration or More Fragmentation

-Finally, the proposal of Libra, coupled with the advancement of the central bank digital currency in China, highlighted the current shortcomings of cross-border payment system (Petrulia, Philippon, Rice and Veron(2019)) and pointed to the potential role of Big Tech and Fin Tech in financial business: it prompted the central banks in advanced economies to embark on the study of central bank digital currency and active use of blockchain technology.

# 4. More integration or More Fragmentation

## 2. More Fragmentation

- There is a rise of populism with extreme right (and left) wing political parties whose ideology and political beliefs contradict the social and economic values and the rule of law inherent in the historical process of the EU.
- Notably, immigration policy divided the EU due to the difficulty to maintain both the humanitarian principle and the principle of free mobility of labor at the same time.
- There is a case of possible division of the Euro area into the southern and northern Euro area, given the wide discrepancy of trade balance among the member countries and the “Greek tragedy”(Stiglitz(2016)).

## 4. More integration or More Fragmentation

-Political leadership both in France and Germany became vulnerable, due to the resistance against the public pension reform (President Macron) and the absence of successor of Chancellor Merkel.

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