Claudia Buch: Economic challenges facing Europe and the world - policy priorities of the Italian G7 presidency and German G20 presidency in 2017

Statement by Prof Claudia Buch, Deputy President of the Deutsche Bundesbank, at the panel discussion with Claudia Buch and Luigi Federico Signorini (Deputy Governor of the Bank of Italy), Collegio Carlo Alberto, Turin, 19 December 2016.

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1. Challenges

In the year 2016 we have witnessed important political events – some of them with unexpected outcomes and market reactions. Financial markets recovered rather quickly from the Brexit vote in June; they first plunged and then went up after the US presidential election in November; markets did not react much to this month's referendum about constitutional reform in Italy.

Post-crisis financial regulatory reforms sought to make the financial system more resilient against shocks. Market responses to the Brexit vote showed the importance of buffers in the system. Market participants built up liquidity buffers before the referendum, and the depreciation of the British pound cushioned some of the adjustment.

But the extent to which we have already seen the longer-term stock adjustment, the revaluation of assets, and the full response of markets to these events remains an open issue. Recent political developments reflect global challenges that go much deeper. There is a great deal of uncertainty about how the rising tide of populism and protectionism will affect the global economy over the longer term. The benefits of globalization are being questioned.

Policymakers must therefore strike the right balance between sustaining integration, fostering economic prosperity, and addressing concerns about inequality. In Europe, the 25th anniversary of the Maastricht Treaty and the upcoming 60th anniversary of the Treaty of Rome remind us of the many achievements of the European integration project. These include 70 years of peace and lasting democracy, freedom of movement, free trade of goods and services, and a rise in economic prosperity for many citizens. A precise measurement of the benefits of economic integration is hardly feasible, but a recent study estimates the gain in GDP per capita due to EU membership at approximately 12% (Campos et al., 2014).[1]

At the same time, economic integration has distributional consequences. Not every individual, not every firm benefits from free trade and from increasing (international) competition. There is a need for appropriate policy responses such that both potential winners and losers continue to share a feeling of belonging together.

Many of the policy issues involved go well beyond the analytical contributions that economists can provide. And they also extend far beyond the policies that central banks have at their disposal. Let me therefore focus on the two main topics that Germany has made its priority under its G20 presidency, which began this month. These topics address two key challenges for global and, in particular, European policymakers: resilience and digitization.

The G20 or "Group of Twenty" is an international forum for governments and central bank governors from 20 major economies. It was founded in 1999 with the aim of studying, reviewing, and promoting high-level discussion of policy issues pertaining to the promotion of international financial stability. The G20 presidency rotates among the G20 member countries – Germany's presidency follows that of China and will be followed by Argentina. While each presidency has its own key projects, continuity is key in the G20 process. With its focus on resilience, the German G20 presidency builds on previous work on structural reforms and growth-promoting policies.

2. Strong real economies are the basis of resilience

More resilient economies are less prone to severe downturns, rebound faster from negative shocks, and adapt more easily to structural changes. The ability of the private and public sector to absorb shocks is therefore an important factor affecting resilience. High levels of debt constrain this ability, in particular if low productivity growth weakens the ability to service outstanding levels of debt. A stable financial system and a resilient real economy are two sides of the same coin.

Yet productivity growth has declined over time in many countries. In the euro area, for instance, labor productivity is currently growing at a rate of 0.4%.[2] It lags behind the growth rates of the US and other advanced economies. The gap in productivity growth between Europe and the US has been widening since the mid-1990s. Empirically, it is difficult to attribute differences in productivity growth across countries and regions to specific factors. Factors such as institutions, demographic trends, or the macroeconomic environment interact and are difficult to isolate.

Regional differences in productivity within countries can also be very persistent. And here I am not referring to regional differences within Italy. Instead, what I have in mind are differences between eastern and western Germany. The former East German states have developed very differently than the West German states since German reunification. After the wall came down and markets were opened up, there was a rapid convergence process. Over the first ten years following reunification, investments per employee that were 30% above the western level made firms more efficient and boosted productivity (IWH, 2014).

In the first half of the 1990s, GDP per capita in eastern Germany rose from 43% of the western German level to 66% (German Ministry of Economics, 2016). From then on, convergence practically stopped. More than 25 years after the wall came down, income per capita still stands at about 70% and productivity at roughly 80% of the western level (IWH, 2014). Eastern German firms remain smaller and less internationally integrated than their western German counterparts; there are few headquarter activities located in eastern Germany.

Hence, unification brought many new opportunities in terms of free travel and gains in economic prosperity. However, the adjustment process was also very painful. Many East German firms became insolvent; unemployment rates increased sharply.

Investment into research and development (R&D) can promote innovations and thus growth. But triggering R&D investment is not easy. In eastern Germany, public subsidies have been used to stimulate R&D investment in structurally weak regions. Recent research shows that such subsidies can indeed increase gross value added and productivity in the private sector (Dettmann et al., 2016). But the effectiveness of public subsidies also depends on the right combination of an educated workforce, a supportive regulatory environment, and demand for new products.

One important insight gained from the recent globalization period is the importance of integrated markets for productivity growth.[3] On the one hand, international trade linkages and foreign direct investment allow technological advances to diffuse, thereby boosting productivity. On the other hand, firms which are small and insufficiently productive cannot shoulder the fixed and variable costs of market entry. Hence, barriers to international integration are more binding for small and mid-sized firms than for their larger – and more productive – counterparts.

3. High levels of debt weaken resilience

Let me come to the second factor that affects resilience – the level of debt. Here, crisis legacies still weigh on the world economy. Debt levels in the private and public sector remain high. At the end of 2013, world total debt (ex-financials) stood at over 210% of global GDP, up from about 160% at the beginning of the 2000s (Buttiglione et al., 2014). More recent data from the Bank for International Settlements covering 42 advanced and emerging economies indicate a further increase in debt at the global level, in particular due to rising debt ratios in emerging market economies. In the third quarter of 2015, total non-financial debt levels amounted to 218% of GDP.[4] In the euro area, public debt currently amounts to 91%; debt of the non-financial private corporate sector stands at 105% of GDP.[5]

Post-crisis reforms of financial regulation play a vital role in making economies more resilient. These reforms have the explicit goal to enhance the stability of financial systems at the national and global level. Many of them are coordinated by the Financial Stability Board (FSB), an international body that monitors and makes recommendations regarding the global financial system. It was established at the initiative of the G20 in 2009.

The key to a resilient banking sector is higher capital. Better capitalized banks have stronger cushions against unforeseen risks. This increases the stability not only of individual banks but also of the entire financial system. Recent research by the Bank for International Settlements shows, in addition, that better capitalized banks lend more to the real economy and have lower funding costs (Gambacorta and Shin, 2016).

Post-crisis reforms were also aimed at reducing the too-big-to-fail problem in the banking sector. Insolvent banks differ from insolvent firms. Because dealing with distressed banks is difficult, large banks typically enjoy an implicit subsidy. Therefore, making large banks more resilient by imposing additional capital buffers has been a major goal of reforms. Other important reforms have dealt with establishing central clearing of derivatives trading, and transforming shadow banking into market-based finance.

Ultimately, these reforms aim at mitigating the negative side-effects of financial integration and allowing countries to enjoy the benefits. There are two ways in which financial integration can contribute to economic prosperity.

First, financial integration allows the channeling of funds to productivity-enhancing investments, which fosters economic growth. Research suggests that financial integration can affect economic performance through higher total factor productivity (Bonfiglioli, 2008).

Second, integrated financial markets can improve international risk sharing and help absorb adverse shocks hitting the domestic economy (Balli et al., 2012). Equity in particular provides an ex ante risk-sharing mechanism, namely a claim on real assets. Debt, by contrast, is a claim on nominal assets and is insensitive to a borrower’s situation. An adjustment to idiosyncratic shocks can only occur through new lending or through haircuts on existing loans after risks have materialized. By contrast, the value of equity adjusts if the borrower’s situation changes.

The stabilizing features of equity contracts have been visible during the European debt crisis. In Europe, debt finance has been more prone to capital flight than equity finance. Furthermore, diversified cross-border equity holdings help detach consumption from business cycle fluctuations. Cross-border equity allows more effective cross-border risk sharing and consumption smoothing. Increased reliance on equity finance would be particularly beneficial in the European Monetary Union, where nominal exchange rates cannot adjust to cope with (regional) macroeconomic shocks.

Yet, the global financial crisis has revealed that financial integration can be a double-edged sword. Financial linkages can lead to financial contagion. Financial markets are highly connected across borders; the financial and real sectors within countries are closely linked. Financial regulation must therefore take a system-wide perspective. Against this backdrop, promoting and improving the international financial architecture has been on the agenda of the G20 for many years.

4. Digital financial services affect the efficiency and stability of financial markets

While financial development promotes global growth, it might also have made "the world riskier" (Rajan, 2005). Therefore, it is important to shape financial regulation and other policies to allow for a beneficial interaction of financial markets and productivity.

The opportunities that are offered by digital technology can be a driving force to achieve this goal. One important topic of the Finance Track under the German G20 presidency is the digitization of the financial sector. The quantity, quality, and diffusion of technological innovations are at the heart of productivity growth.

One explanation for the growing productivity gap between Europe and the US is strong productivity growth in the US. This, in turn, can be attributed to information and communication technologies or ICT (Havik et al., 2008). The contribution of ICT to US growth went up from 43% for the period 1971–1995 to 59% for the period 1995–2000 (Jorgenson et al., 2008). The growth contribution of increased investment in ICT capital almost doubled. ICT is a general purpose technology with a broad impact on many sectors of the economy.

New digital technologies might spur productivity growth in a similar manner as the last wave of information and communication technologies. They can contribute towards closing gaps in productivity. We therefore need policies that create an environment in which such innovations diffuse easily and create positive spillovers.

Innovative digital financial services can contribute to well-functioning financial markets. Fintech firms and innovations such as crowd-funding and distributed-ledger technologies are at the center of this debate. Fintechs can facilitate access to financial services. These innovations can foster competition, lower transaction costs, and improve risk sharing – thus promoting innovation and growth. But financial innovations might also affect systemic risks. They might induce pro-cyclical behavior. Risks posed by cyber-crime need to be monitored closely and, where necessary, addressed. This is to say that digital innovations should not undermine secure, transparent, and stable financial markets.

5. Conclusion

There is no lack of short- and long-term challenges facing Europe and the world. Under the German G20 presidency, we will be addressing two important issues: resilience and digitization.

Strong real economies are the basis for resilience. Economic growth is therefore not an end in itself. Strong growth is rather the basis for inclusive growth, as it opens up space for redistributional policies. Strong growth is also built on innovation, which can contribute to sustainable growth.

Robust financial markets are the second pillar of resilience. As we are completing the reform agenda, we are gradually moving from policy implementation to (ex post) impact assessments. We need impact assessments to demonstrate the long-term benefits of the reforms – benefits in terms of financing innovation, growth, and the allocation of risk in the economy. We need to look at the effectiveness of individual reforms, the interaction between reforms, and their aggregate affect.

At the global level, maintaining a dialogue on economic policy is crucial. The G20 as well as the G7 are fora that play an important part in addressing the above challenges. They allow countries to learn from best practice across countries and to develop their policy framework. The member countries have diverse experience with regard to stability issues and national policy discussions. Every financial crisis may be different, but core elements and mechanisms repeat themselves. Therefore, by sharing experiences, policymakers can collectively learn from each other and improve their policy responses.

6. References

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[1] This number refers to the average effect per country for the whole post-accession period up to 2008.

[2] This number refers to the year-over-year growth rate in the third quarter of 2016 (ECB calculations based on Eurostat data).

[3] For a review of recent literature, see Melitz and Redding (2014).

[4] These are aggregate numbers based on conversion to US dollars at purchasing power exchange rates.

[5] These figures refer to the first quarter of 2016.