Liviu Voinea: Europe - managing the upswing in uncertain times

Speech by Mr Liviu Voinea, Deputy Governor of the National Bank of Romania, at the Conference CEPS-IMF Spring 2018 Regional Economic Outlook, Brussels, 15 May 2018.

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Dear Governor Smets,

Dear Director of the IMF's European Department Thomsen,

Dear CEPS Director Gros,

Thank you for having me here. It is an honor for me to speak at the launch of the IMF Regional Economic Outlook for Europe. This report is remarkable in many respects: it is comprehensive, well-documented and clearly written, with strong messages and judicious policy recommendations. It comes in times of uncertainty, when the European economy is rebounding, but challenges remain; in particular, the business and financial cycles of advanced economies are so dissimilar to those of the new member states that a distinct analysis is warranted.

The first chapter of the report is entitled "Managing the upswing in uncertain times". The report shows that growth has recovered in advanced European economies and even picked up in the new member states, some of which are now having large positive output gaps. Moreover, growth forecasts are strong in 2018, but growth is not taken advantage of to advance with fiscal consolidation and structural reforms. This recovery has created more than 12 million jobs in the EU since 2013, exceeding pre-crisis peaks. Consequently, unemployment fell by a total of 5 percentage points in NMS and 3 percentage points in EU-15 over the same period.

Uncertainty, however, does not mainly come from the economic environment; it comes from the erosion of trust, based on an unbalanced distribution of globalization benefits, a long and slow recovery, decentralization and fragmentation – as the IMF's First Deputy Managing Director David Lipton pointed out in a recent speech[1] . The REO also speaks about the weakening support for globalization, which affects global trade and long term growth prospects, a thesis linked to the apparent retreat from cross-border integration and the move from multilateralism to bilateralism.

And the report is right, in my view. After 3 decades of deregulation and liberalization, the consensus is being threatened by the return to protectionism. East European countries, being at the receiving end of capital movements, are the short term losers of what it looks like an exit from globalization as we knew it. I call this exit from globalization "Glexit" – which is much more than Brexit or any other individual exits. In the banking sector, Glexit means further deleveraging and higher financial burden for already over indebted nations, companies and households.

We can do more, together, to rebuild trust in institutions, to improve the governance, and to make sure that the economic upswing that we are now enjoying will be more evenly distributed, that it will reach every household and company. While this is a long time-effort, we need to do more to put our house in order now.

Jerome Powell, the chairman of the Federal Reserve, referring to the assessment of risks in emerging economies, said that three elements are important:[2] first, the vulnerabilities in the EMEs themselves; second, the evolution of advanced-economies monetary policies; and, third, how markets might respond to that evolution. Emerging economies are takers in the global markets; we cannot do much about the last two elements mentioned above, which are exogenous. Our job, our duty, is to prevent the accumulation of domestic vulnerabilities, because deterioration in a country's economic conditions makes it more vulnerable to adverse external shocks.

High growth in emerging economies is good as long as it is sustainable. I would recall here a famous answer from Henry Ford, the father of the car industry, when he was asked about his preferred color for the new T-model: “Any color, as long as it’s black”. Any growth is good, as long as it is sustainable and, I would add, fairly distributed. True, emerging economies need higher growth rates to catch-up with the more advanced economies. True, potential GDP is a non-observable variable, like many others such as inflation expectations, non-accelerating inflation rate of unemployment, or the one to which it is directly linked – the structural deficit. New Member States have probably higher potential growth rates than the ones we are now estimating, and this estimation is subject to constant change, based on new information in the data series, but also on improved endowment with and efficiency of labor and capital. Nevertheless, these non-observable variables become visible, sooner or later, in two indicators that eventually separate oil from water: the twin deficits.

Let me start with the case of Romania. In the aftermath of the global financial crisis, we had one of the largest adjustments of the budget deficit in the EU: from 9.5% in 2009 to less than 1% in 2015. Romania exited the excessive deficit procedure in 2013 and also in 2013 reached the Medium Term Objective of 1% of GDP structural deficit, down from 8.8% of GDP in 2009. Since I was the Budget Minister in 2013 and for most of 2014, and I was responsible for the IMF and EC negotiations, I can praise the role played by the IMF and the EC in the three successive agreements (2009–2015). The current account adjustment was also impressive, from –13% in 2007 to just –1% in 2013–2015. However, in the last couple of years, the trend of fiscal consolidation has been reversed. This has also impacted the current account, which has deteriorated by 2.2% of GDP, of which 2.1% of GDP came from the budget deficit widening. The main advantage of the country is its low level of public debt, but this can be reversed in the medium term unless a prudent policy mix is implemented, including a gradual return to MTO.

Broadening our perspective, all EU countries have adjusted their budget deficits over the last 10 years. Most of them also adjusted their current account deficits. In fact, the downsizing of current accounts can be attributed to both public and private sectors. This means that aggregate demand was affected for a longer period, and measures to stimulate it, when the economies experienced negative output gaps, were needed. Despite very low interest rates, credit was not a main driver of the recovery; and public investments, as the report outlines, are on average 2 percentage points of GDP lower than their pre-crisis levels.

Although it is nowadays a demand-led recovery, we do not have sufficient demand-push inflation, with the notable exception of countries that have closed the output gap – and these are the New Member States. This justifies the report recommendation of further accommodative policies from the ECB. However, as Mr. Thomsen highlighted in his presentation, policymakers need to seize the good times to advance further with fiscal consolidation and structural reforms. But the low rate environment and the strong sovereign-bank nexus are feeding the beasts and provide the wrong incentives for reforms.

This is where policy trade-offs step in. Monetary policy has been overburdened in times of crisis, trying to address the market failures and the pro-cyclical fiscal policy. Yet, monetary policy is not a universal medicine, and it cannot work in isolation. Jens Weidmann, the President of Bundesbank, once made an analogy between monetary policy and Coca-Cola’s all-round curative properties: monetary policy is also currently being branded as a cure for assorted ills. As well as its own actual mandate of keeping prices stable, some people seem to be under the impression that it should be used to strengthen growth, lower unemployment, safeguard the financial system and guarantee citizens adequate interest rates”[3]. Yet, monetary policy can only buy time for structural reforms in the short run, while tensions are accumulating in the background.

One major source of tensions refers to the wage policy. Chapter 2 of REO discusses in much detail the “European wage dynamics and labour market integration”. The main messages of this part can be summarized as follows: a) in EU 15 wages are subdued because they respond very slowly to changes in unemployment and are closely related to inflation and inflation expectations, which are unusually low; b) in NMS wage growth responds very quickly to changes in unemployment, and inflation expectations play a lesser role; c.) average wage increases in NMS were much higher since 2012 than in EU-15; d.) about one quarter of wage growth in Europe can be explained by EU-wide and group-level factors; e.) there was a decrease in unemployment, but also an increase in involuntary part-time employment; f) migration plays a role in the faster increase in wages in the countries of origin.

One hot debate topic in Europe these days –reflected in the report- is the flattening of the Philips curve. Subdued wage growth, together with subdued inflation, are presented among the risks in the euro-area – while the divergent wage growth trends between euro area and emerging Europe are considered to reflect differences in labor market slack. Alternative explanations provided by recent international literature for the disappearance of the Philips curve refer to under-measuring the amount of spare capacity (slack) in the labour market; a lower natural rate of unemployment; lower or more anchored inflation expectations; and changes in expectations of real pay growth.

The IMF' REO presents an innovative econometric model reshaping the wage Philips curve against a measure of unemployment gaps. This shows that the Philips curve is flatter in the euro area than in the NMS, but that in general it still works. However, caution in interpreting the results is needed because this model splits the EU countries into three distinctive groups (Germany a group of its own, some euro-area countries and some NMS countries including euro and non-euro area, but excluding Romania and Bulgaria – probably because, in particular for these 2 countries, any measure of unemployment should be regarded prudently given the large emigration and underground economy).

Let us remember that catching-up is an inflationary process in itself, as postulated by Balassa-Samuelson. Maybe not much convergence is taking place between North and South, but catching-up has continued throughout the crisis between East and West – as Daniel Gros recently concluded in a CEPS study. Migration has led to upward pressures on wages in the emerging Europe and to downward pressures in the advanced EU. The contribution of net emigration to the middle income trap for emerging economies should also be further studied.

Still, I would like to share with you some preliminary results of a work in progress[4] that I am undertaking on the relationship between wage growth and inflation. If we think in terms of stocks instead of flows, we can introduce the concepts of wage gap and inflation gap (just like the IMF's REO discusses about unemployment gap, and the classical theory has the output gap). Wage gap refers to the cumulated gap between current wage and a peak reference wage value in the past. The permanent income hypothesis is fundamentally flawed in times of crisis, because of uncertainty of future income. The only certain reference value lies in the past, not in the future: and that is why current consumption is influenced by past income. A recession is a game – changer. In a crisis, the reference is not ahead of us, but it is rather in the past. Retirement savings and linear employment prospects are uncertain. People relate to their peak gains in the not so distant past rather than to uncertain future gains. Inflation gap refers to the cumulated deviation of present inflation from the target inflation or, in the absence of such, from its long-time average. We also allow for the wage Philips Curve to be non-stationary: it moves over time, and it is absolutely normal to do so. Reference wage values, social preferences, jobs' characteristics, skill endowments and even Central Banks' targets, they all change over time – hence, the impact of wage gaps on inflation cannot be the same in different time periods. The preliminary finding of our model is that inflation does not increase close to or above its target level until the wage gap is closed. For Philips Curve to work, the loss of welfare from a negative wage gap has to be fully compensated first – as a stock measure, not as a flow. The policy recommendation from here is that countries which closed their wage gap should be much more prudent in further wage increases – because they will be seen in inflation much faster and larger than in the recent past. And for countries which have not closed their wage gap the implication is that inflation will remain subdued until this happens.

I fully agree with the IMF's recommendation that central banks in NMS with their own currencies should be alert to the inflation risks of higher wage growth, while bearing in mind that raising policy rates could trigger capital inflows and exchange rate appreciation – which could further deepen current account imbalances. While the real monetary policy stance may differ between euroarea and emerging Europe, there is broad heterogeneity even among emerging Europe. This is why it is important not to give the wrong incentives to capital flows.

This reminds me of my days as a child when, being asked what I want to become when I grow up, I confessed that I wanted to be a firefighter. It turns out that I am now a central banker, which is not far from being a firefighter in these uncertain times.

National Bank of Romania has started the tightening cycle of the monetary policy, to contain the higher inflation and inflation expectations. Although most of it is supply-side and temporary, and fighting fiscal loosening with monetary tightening is a sub-optimal policy mix, we considered that the 3 rate hikes we implemented this year were warranted to preserve a hard-fought public good: price stability.

Coming to an end of my intervention, I would like to express a few thoughts on one of the most important remarks of the REO. It states that "the recovery provides an opportunity to move faster to deepen the Economic and Monetary Union". The report details three lines of action in this regard: completing the Banking Union, creating a central fiscal capacity, and advancing with the Capital Union.

Too much financial innovation, deregulation and the blind, theological belief in self-regulating markets have brought us here, back to the era of re-regulation; but coordination is needed for that, and Glexit is threatening this coordination.

It is however undeniable that the completion of the Banking Union is of paramount importance. However, there is still no consensus on operationalizing the EDIS, on debt mutualization, on setting the minimum requirement for own funds and eligible liabilities, on the features of the fiscal union, and the list could go on. I think that the Union should also clarify the fine balance between the consolidated microprudential supervision of banks and national accountability in terms of resolution. The home-host issue has not been dealt with yet. Moreover, the European financial architecture is populated with unfinished, incomplete, or untested mechanisms created after the crisis. Even so, my message on the reform of the European financial sector is twofold. First, the reform is fundamental for the success of the European project. Romania welcomes all the European Commission's initiatives aimed at enhancing supervision, consolidation, and accountability in this area, and we will do our best to help reach a consensus on these proposals during our incoming EU Presidency. Second, it is also fundamental for the integrity of the European project that euro-area should not be ring-fenced; the reform should still make it possible for non-euro countries to join euro, when they will be ready, on a level playfield.

Price stability and financial stability are two sides of the same coin. You can't have one without the other – this is a lesson that history has recently taught us. And none of them is possible without credible public policies.

1. Lipton, David (2018), "Trust and the Future of Multilateralism", Introductory Remarks for the Eurofi High Level Seminar, Sofia, Bulgaria, April 30, 2018.

2. Powell, Jerome H. (2017), "Prospects for Emerging Market Economies in a Normalizing Global Economy," speech delivered at the 2017 Annual Membership Meeting of the Institute of International Finance, Washington, October 12.

3. Weidmann, Jens (2017), "Monetary policy and the architecture of the euro area", speech at the Deutsche Bundesbank's Capital City Reception, Berlin, 29 May 2017

4. Voinea, L. (2018), “Explaining the Post-Crisis Philips Curve: Wage Gap Matters for Inflation”, manuscript