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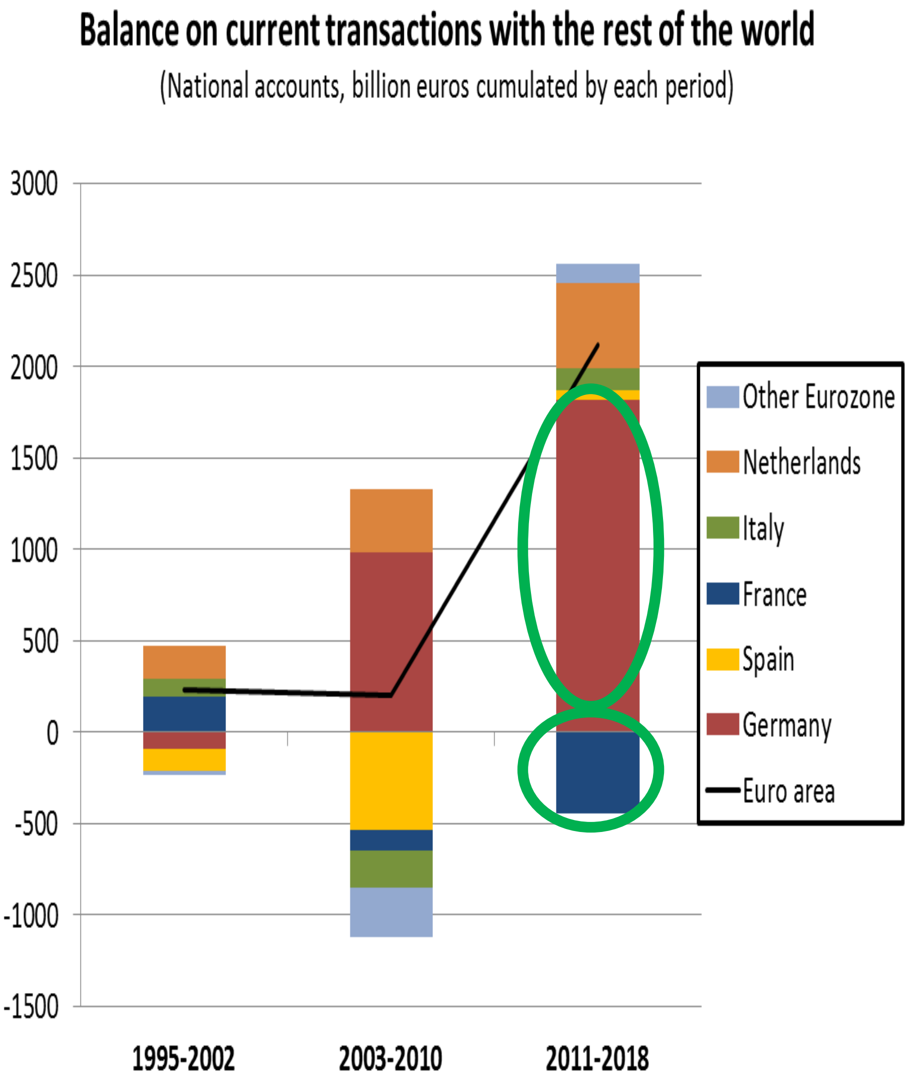
Chief Economist Panel - Brussels, 29 June 2017

Rebalancing the euro area: insights from BDF research

Marc-Olivier Strauss-Kahn
(Director general, Banque de France) *

** Views expressed are those of the author and not necessarily those of the Banque de France*

Large/persistent euro area (EA) current account imbalances



Source: European Commission, Ameco dataset, total Economy. Definion ESA 1995. The balance on current transactions is cumulated over three periods of eight years: 1995-2002; 2003-2010; 2011-2018.

3 periods of 8 years:

1995-02: limited imbalances

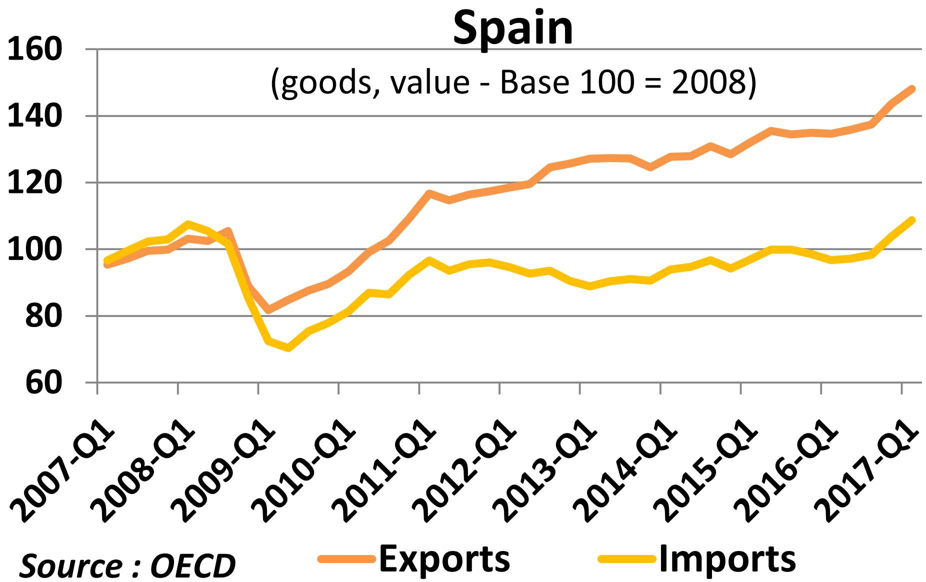
2003-10: ↑ internal imbalances but EA balance

2011-18: larger/persistent imbalances, internal (see FR vs. GE) AND external

OUTLINE:

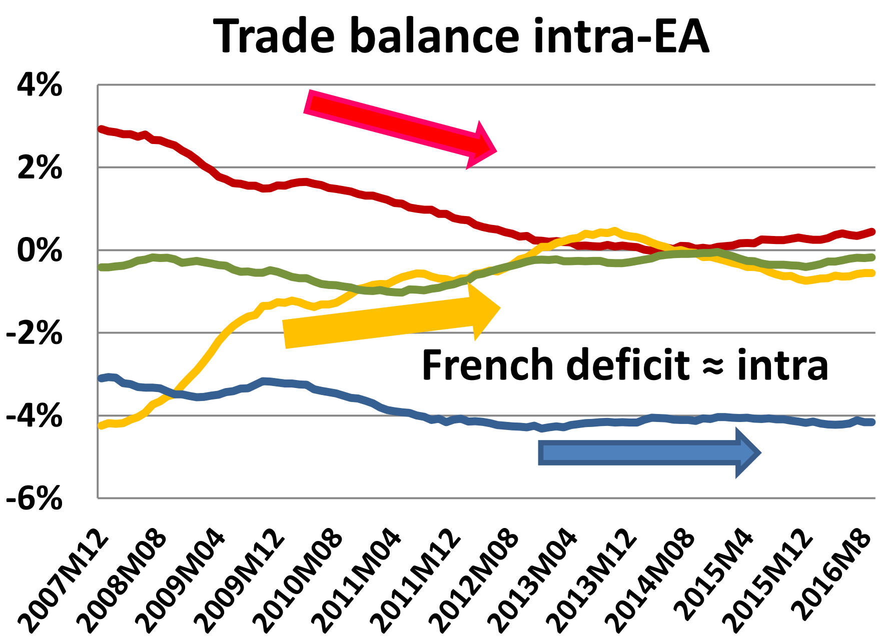
1. Price Competitiveness
2. Non-Price Competitiveness
3. Need for a regional approach

…Reflecting different evolutions of both X/M & intra/extra EA

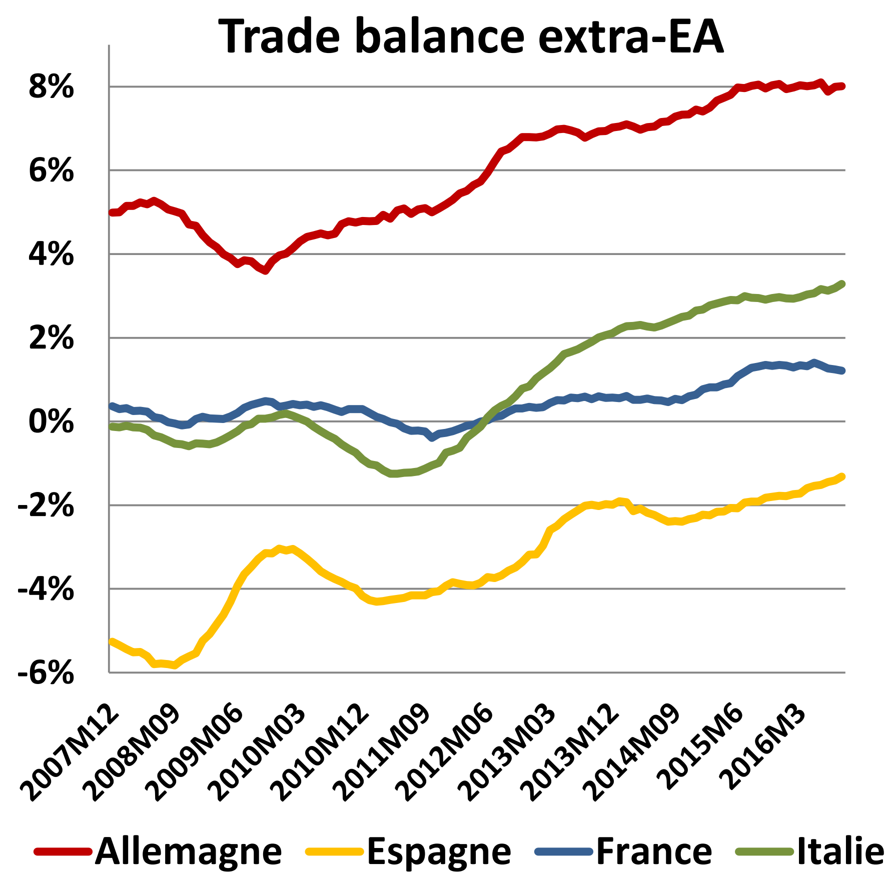


Source : OECD

Example of Spain : its shift from a deficit to a surplus is due first to less imports (demand side) and, then, to more exports (supply side + structural reforms). Annex 1



Source : Eurostat, BDF calculations.



1. PRICE COMPETITIVENESS: low RER-elasticity of export

Focusing on exports, trade elasticities are weak, which implies that large changes in real exchange rate (RER) may be required to rebalance

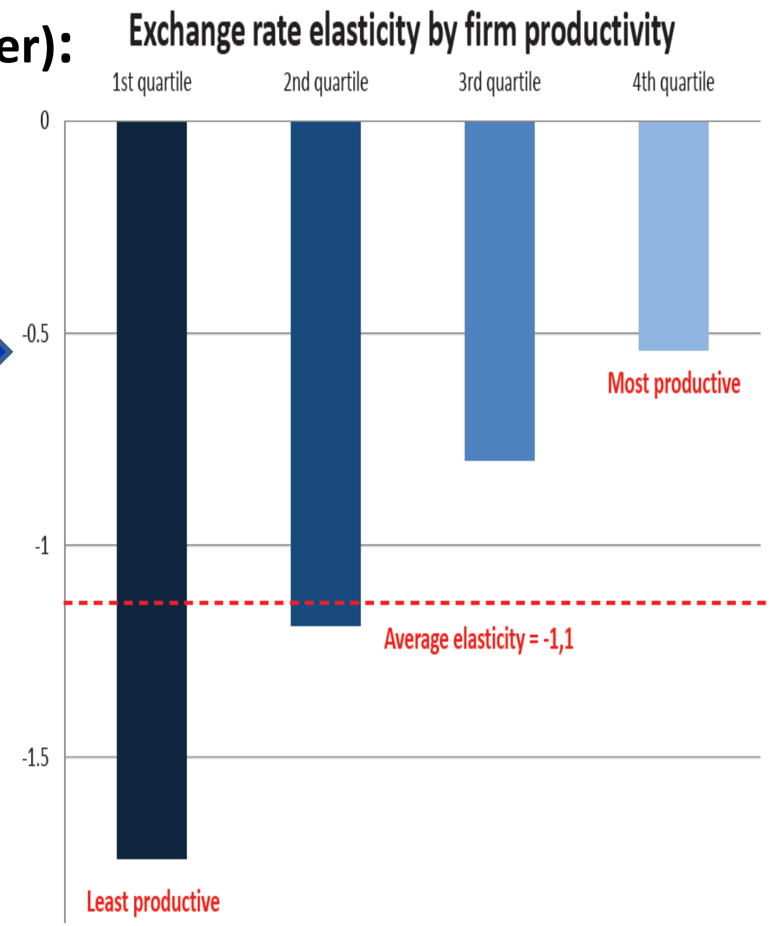
Along the extensive margin (theoretical paper):

non-exporting firms should be productive enough (Di Mauro/Pappada, 2014)

Along the intensive margin:

large productive firms dominate aggregate exports but only weakly react to Δ RER (Berthou/Dhyne, 2017)

This applies even if Marshall Lerner condition verified within the EA, suggesting that ΔRER (e.g. due to Δ relative inflation rates) can, <u>in principle</u>, contribute to adjusting trade balance (Bussière & al., 2016).



Sample : 11 EU countries: BEL, EST, FRA, FIN, HUN, ITA, LIT, POL, POR, SLK, SLV.

1… and weak efficiency of cuts in Unit Labor Cost

After the crisis, many MS with deficits have tried to reduce labor costs, notably: FR, ES, GR, IT, PT. Let's focus on FR with persistent deficit.

Tax credit scheme (CICE) adopted as of 2013:

- **€19 bn in 2016, around 0.85% of GDP (proportional to wage bill).**
- **But in the short-run (2013-15), little impact on exports is found (Carbonnier & al., 2017).**

This may be explained by :

(i) low RER elasticity of exports,

(ii) firms did not perceive the program as permanent,

(iii) firms took the opportunity to improve their margins.

2. NON-PRICE COMPET (NPC): quality/financing/innovation

- **Quality**: let's go on with the example of France.

  French exports suffer more from an insufficient quality-price ratio than from poor product or geographical positioning. Estimated contributions of NPC place France significantly behind Germany (main competitor). French NPC deteriorated further after 2008 (Bas & al., 2015).

  Even over 2000-07, NPC of French exports lagged behind that of Germany (Berthou/Emlinger, 2012).

- **Financial frictions:**

  Relevant for long distance destinations (Bourgeon/Bricongne, 2016).

  USD funding matters to export to USD destinations (Berthou & al., 2017)

- **Innovation**: the most productive exporting firms have more incentives to innovate in response to positive demand shocks (Aghion & al., 2017).

2… while public funding of innovation is not enough

The public share in R&D activities is ≈ 35% in the EU (tax credit or direct grants, source: Eurostat).

Public intervention is useful but cannot substitute for the emergence of venture capital funds (Tirole/Landier, CAE notes, 2016).

Reforming the Research Tax Credit in 2008 had (Bozio & al., 2014):

- **a positive but limited impact on R&D investment,**
- **no impact on innovation as measured by patent counts.**

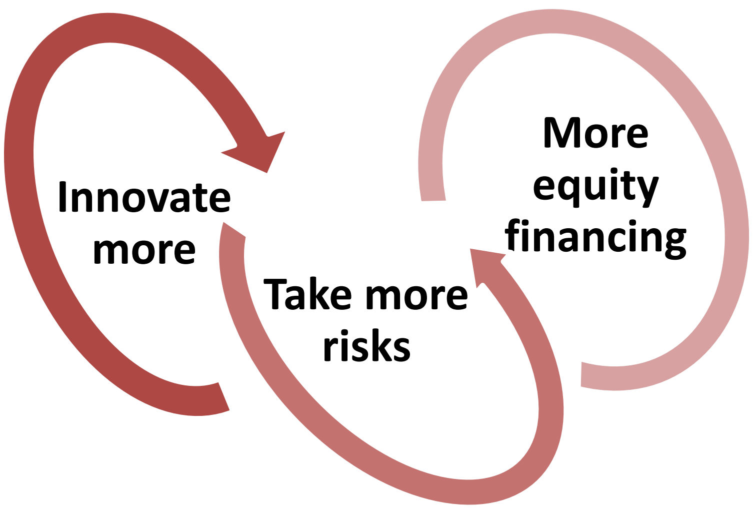
Literature shows ambiguous results as regards the efficiency of public support to innovation.

3. NEED FOR A REGIONAL APPROACH

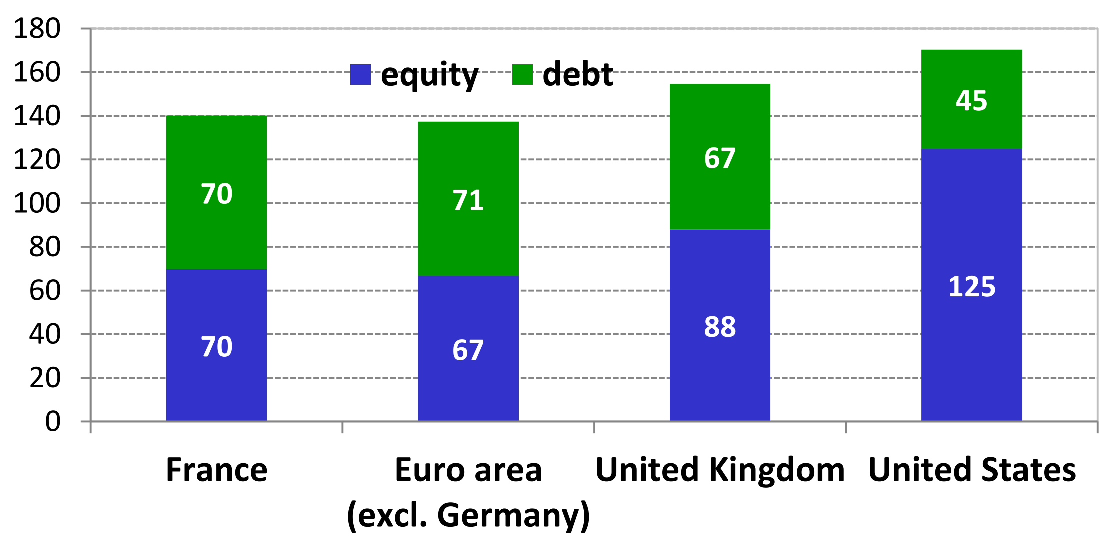
REGIONAL SOLUTIONS FOR REGIONAL CHALLENGES

➢ Towards a Financing Union for Investment/Innovation

Innovative projects are risky & take time to pay back: equity > debt



NFC liabilities: net equity capital and financial debt, % of GDP



Thus, policies in favor of equity financing are called for:

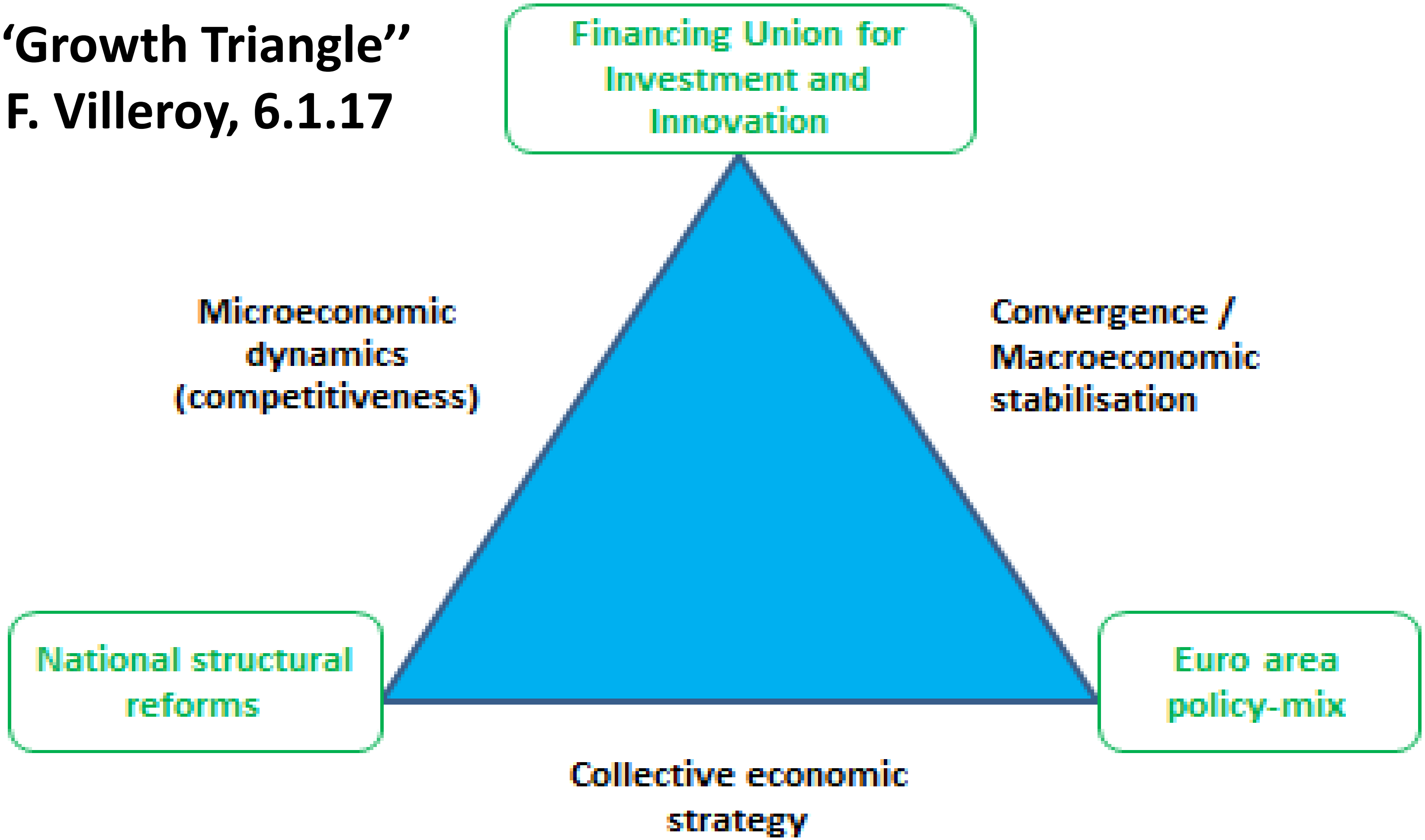
- Capital Market Union (CMU) with Banking Union & Junker Plan
- Taxation system less biased in favor of debt financing [Annexes 2 & 3](#)

3… And towards a better EA governance

➢ More coordination of national policies (fiscal & structural)

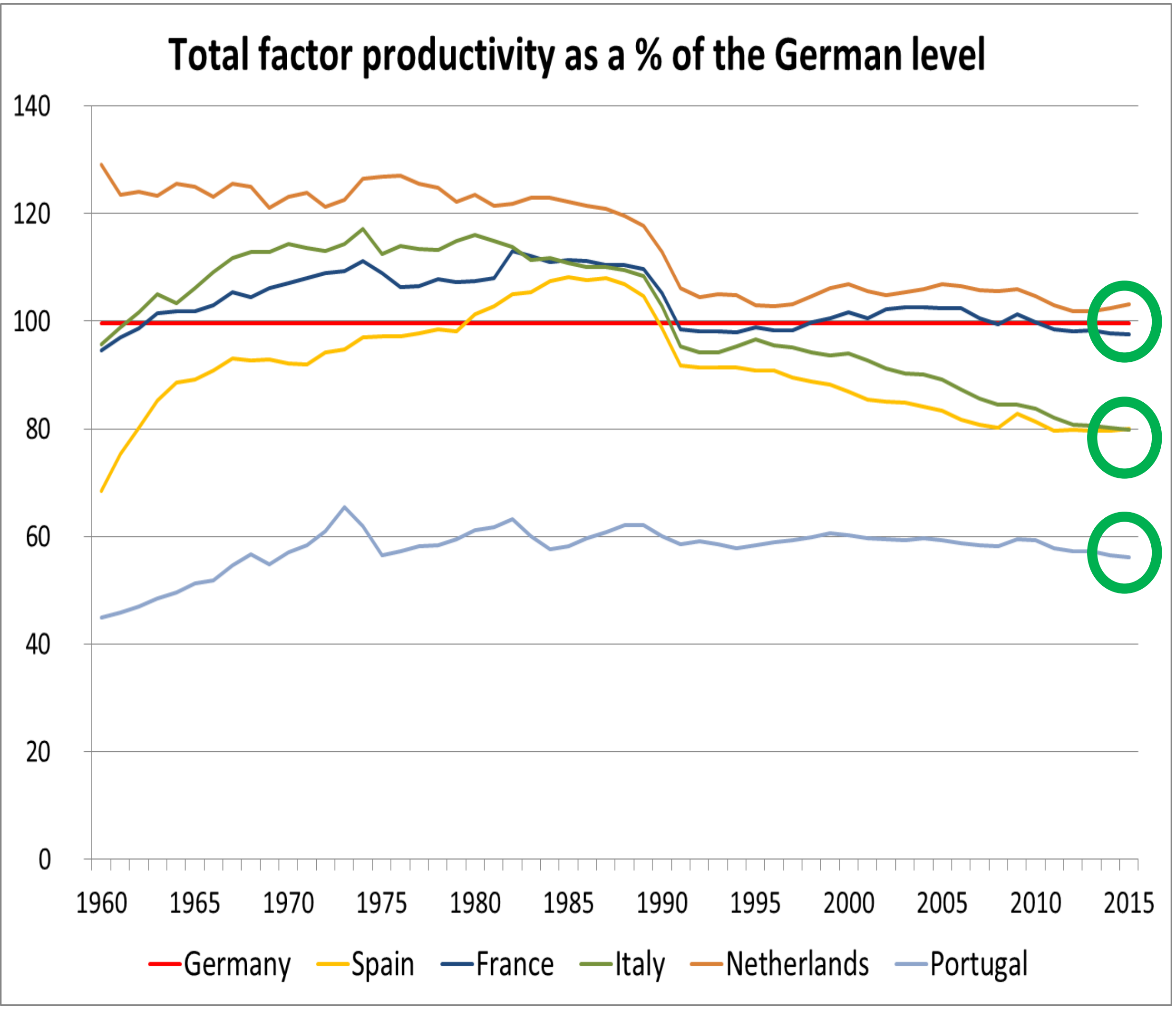
Stimulating public/private spending in surplus countries (Germany "Plus": e.g. infrastructures) = efficient way to resorb intra/extra EA imbalances.

"Growth Triangle"
F. Villeroy, 6.1.17



THANKS

Annex 1a: Diverging productivity levels, with 3 groups



Source : Bergeaud, Cette & Lecat, 2016

- **3 groups:**

1/ High productivity: DE/FR/NL

2/ Diverging: ES/IT

3/ Non-converging: PT

- **TFP convergence needed for a sustainable EA in the long run**

- **Structural reforms are of the essence: cf. Spanish case**

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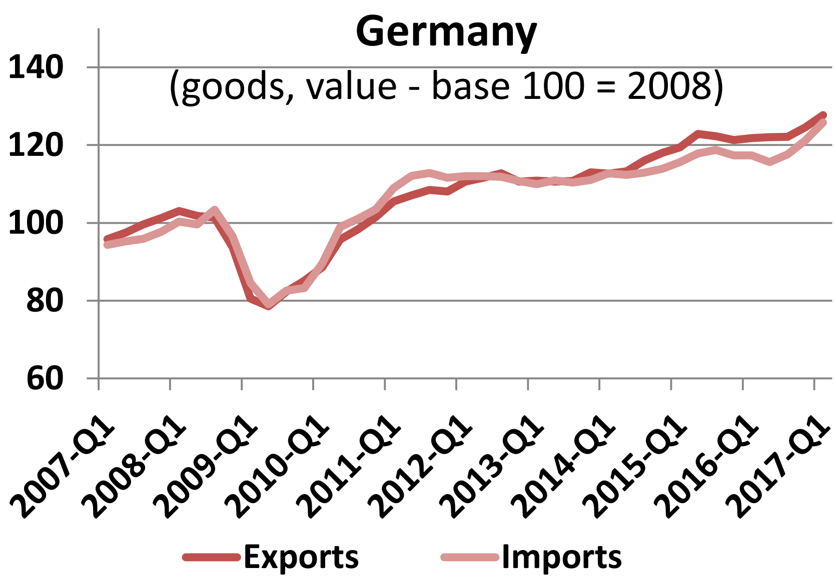
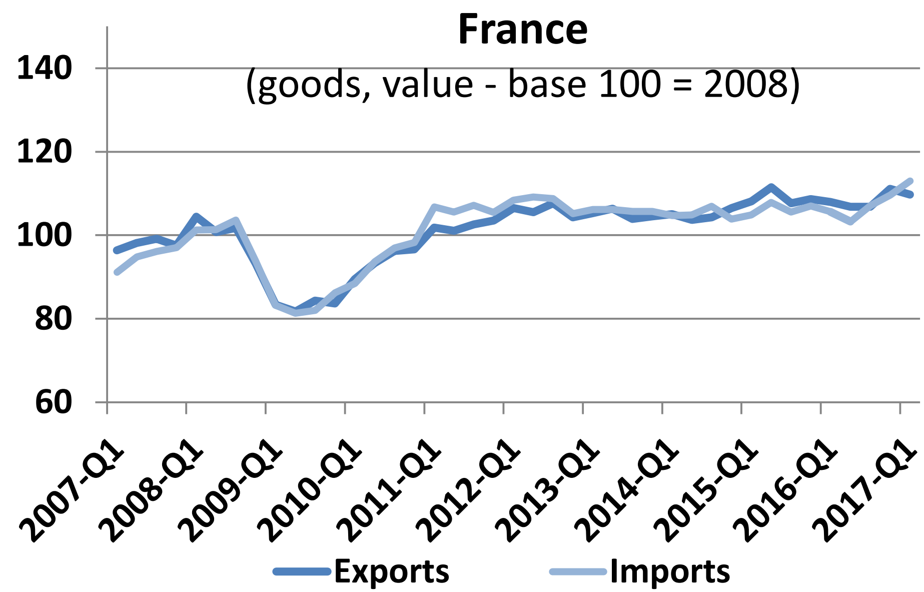
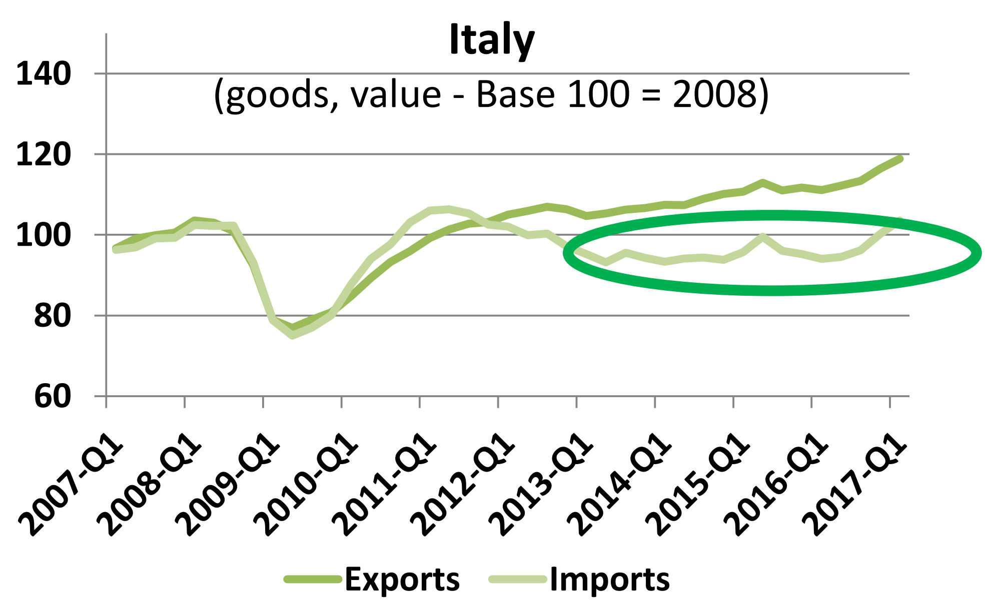
Annex 1b: Exports / Imports DE-FR-IT







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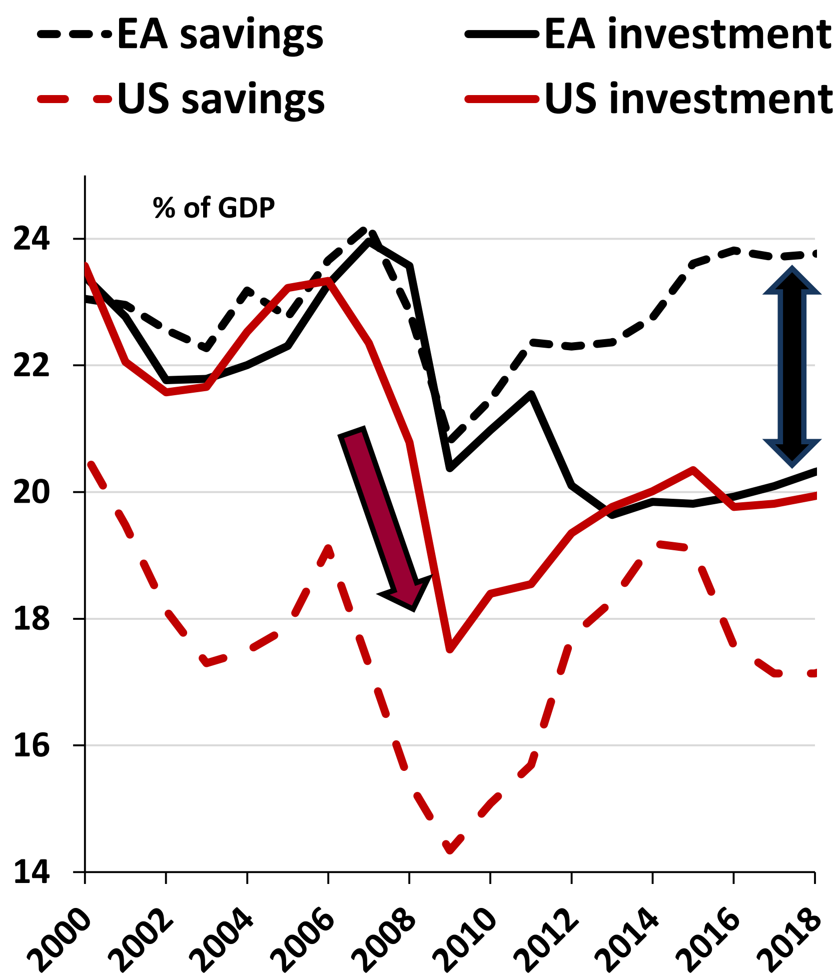
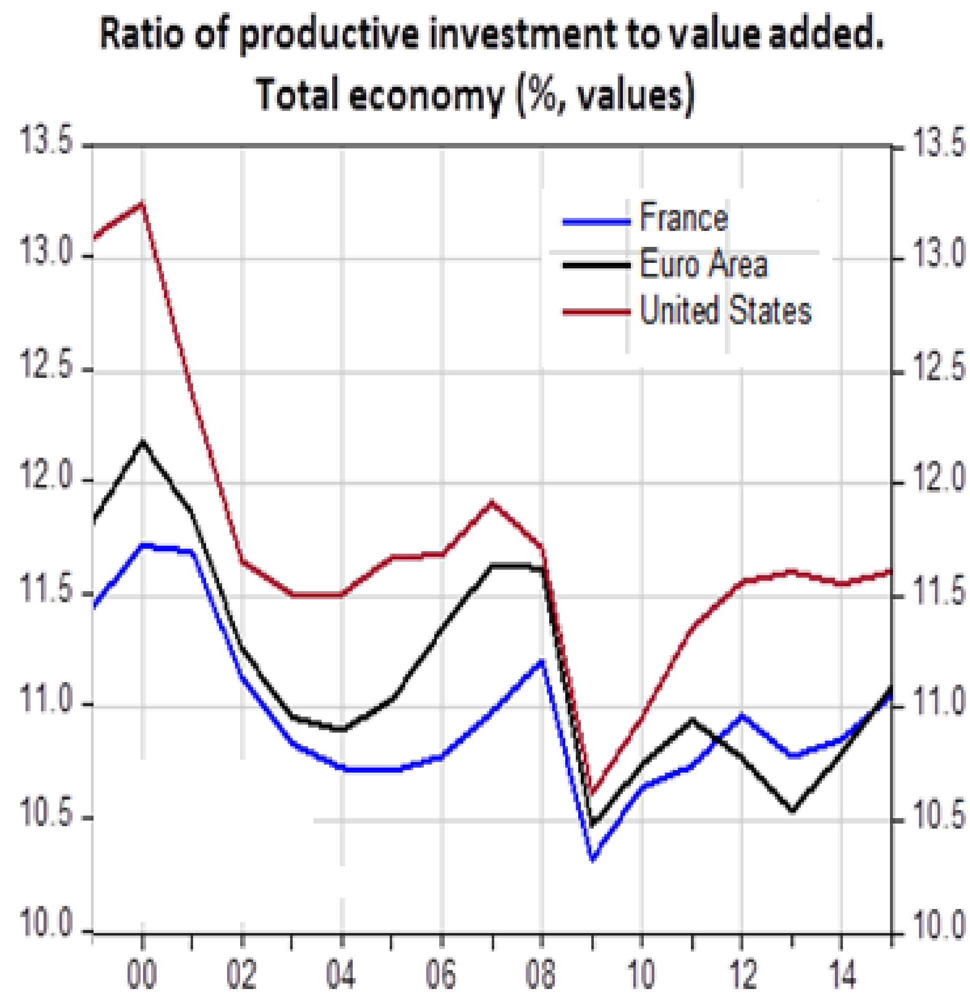
Source : OECD

Annex 2: The EA is lagging ‘structurally’ behind the U.S.

<u>Investment gap</u> & <u>productive investment</u> (equipment + intellectual property)





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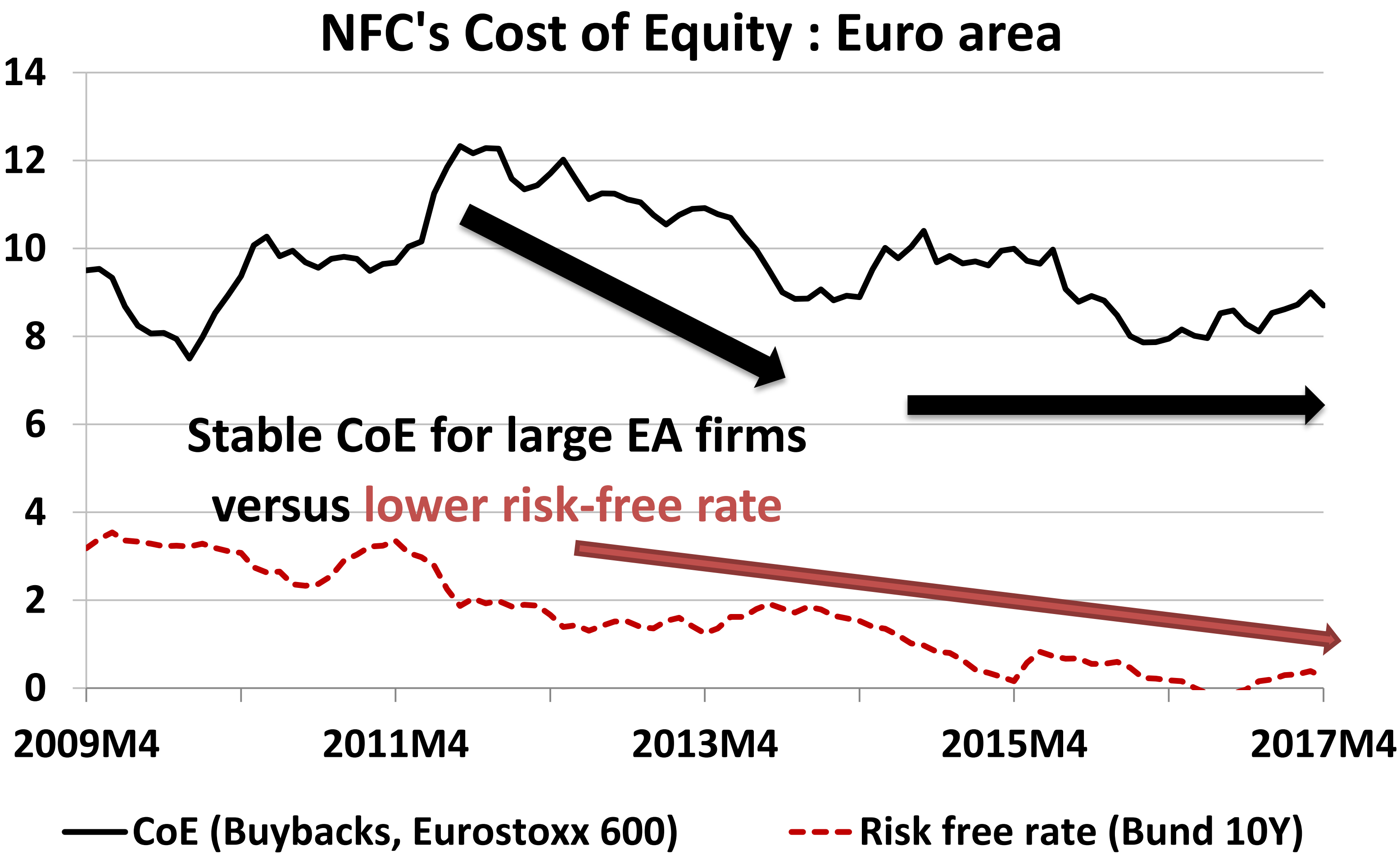
Annex 3: Cost of Equity (CoE) and risk-free rate

Despite low(er) risk-free rates, CoE has remained ± stable & high



CoE = expectations of total cash flows to shareholders, incl. both dividends and share buybacks

Source: Bloomberg, Datastream. BDF estimates.

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