Achilles' heel? Relative price adjustments in the Euro area.

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The focus of Euro reforms and what they miss

- **Banking Union**. Similar rules, common supervisors, access to liquidity.
- **Fiscal Union**. Partly common budget, partial mutualization of debt
- Both highly desirable. Avoid doom loops. Give fiscal space
- But, to function well, need also a third leg: the adjustment of relative prices.

The role of relative price adjustments in a common currency area

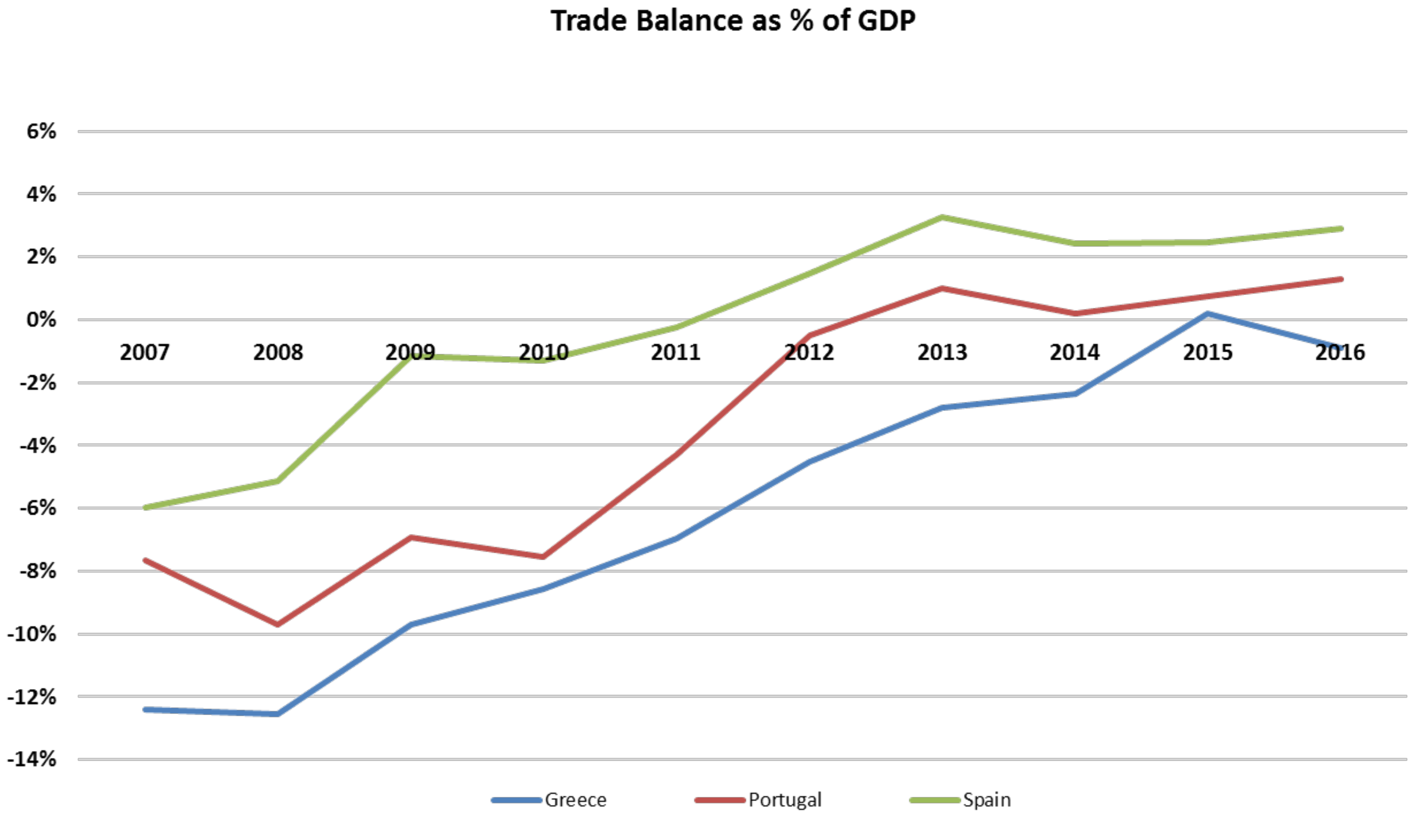
- If country affected by weak domestic demand:
  Right solution: Fiscal policy

- If country affected by weak foreign demand:
  Right solution: Adjustment of relative prices

- Indeed, fiscal policy is wrong policy tool
  Slows down the needed price adjustment

- If uncompetitive, need either wage flexibility, or higher productivity growth (but not a systemic solution)

An impressive success?



Source: National Statistical Authorities (via Haver Analytics)

The role of exports, imports, and prices

Table 1			
	Greece	**Portugal**	**Spain**
	Average rate of change 2008-2016		
2007 TB/Y	-12.42%	-7.64%	-5.99%
2016 TB/Y	-0.89%	1.30%	2.89%
Annual Change	1.28%	0.99%	0.99%
Contributions of			
Exports	0.28%	1.32%	0.87%
Imports (-)	-1.12%	0.58%	-0.21%
Rate of change of price of exports relative to imports	0.27%	0.71%	-0.52%
Annual rate of growth	-3.27%	-0.48%	-0.07%

- Three main conclusions:
- A very costly adjustment. Look at output growth.
- Large differences between countries:
- Greece: Mostly import compression
- Spain: Mostly exports growth
- Portugal: more complex (imports and reexports?)
- Little change in relative prices. Wrong way for Portugal and Spain.

The role of import compression

Table 2 . Output gap adjusted trade balances			
	Greece	**Portugal**	**Spain**
Output gap 2007	9.4%	1.8%	5.0%
Output gap 2016	-12.9%	-6.2%	-5.8%
Output gap adjusted TB/Y 2007	-8.5%	-6.7%	-6.0%
Output gap adjusted TB/Y 2016	-6.2%	-2.0%	0.3%

Import compression, good or bad?

- Good if the initial deficit reflected an unhealthy boom.
- Bad if it reflects a collapse of output.

Can do the adjustment, using OECD output gaps.

- Spain in good shape.
- Portugal part of the way
- Greece: little change.

Warning: Output gaps in real time and in retrospect.

Table 3. Output gaps and the (re)writing of history			
	Greece	**Portugal**	**Spain**
Output gap 2007 as of then	0.7%	-3.4%	-0.1%
Output gap 2007 as of 2016	9.4%	1.8%	5.0%

- Note the rewriting of history.
- Because output has declined so much, it is tempting to think that it was too high to start, and so to be less worried about output decline.
- Honest revision or de facto bias?
- For same reason, take current output gaps with grain of salt.
- If much larger today, then adjustment of trade balance has been more limited.

The action and puzzles behind export growth

Table 4. Role of Productivity, wages, ULCs, and markups			
	Greece	**Portugal**	**Spain**
	Average rate of change 2008-2016		
Productivity growth (per worker)*	-1.56%	0.49%	1.40%
Wages**	-1.70%	0.53%	1.76%
Unit Labor Cost	-0.03%	0.02%	0.13%
GDP deflator	0.28%	1.04%	0.40%

* GDP per worker, Greece and Portugal. GDP per hour, Spain
** Average wage per worker, Greece and Portugal, hourly earnings, Spain

- Poor productivity growth.
  Dismal in Greece, mediocre in Portugal, better in Spain.
- Subdued nominal wage growth
- Small increase in nominal unit labor costs
- But increase in markups, not much improvement in real exchange rates (ΔREER_CPI –ΔREER_ULC = 1% for all 3 countries)
- Not the textbook adjustment. Larger profits rather than lower prices. Will it sustain export growth?

Tentative conclusions

- A costly and painful adjustment in all 3 countries
  - Ten years of extremely low or negative growth
  - Likely to be successful in Spain, probably in Portugal
  - Unsuccessful so far in Greece.
  - More generous fiscal would not have solved that problem.

- Lessons?
  - Maybe the original shocks (entry into euro) will not happen again.
  - Better labor relations to facilitate wage adjustments
  - Higher average inflation would facilitate the adjustment
  - Realistically: Will never work very well. ☹
  - But the alternatives have their own shortcomings ☹