Abstract for Momentum 2017

Spillover Effects of a Demand Boom in Northern Europe on Output and Employment in Southern Europe

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Summary: We calibrate a closed multi-regional input-output model with data from the World-Input-Output Database (WIOD) to carry out an impact analysis. The model yields estimates of spillover effects of final demand shocks in surplus countries (in Northern Europe) on income and employment in deficit countries (in Southern Europe).

1 Research Question

The euro area witnessed the emergence of large internal current account imbalances in the period leading up to the Great Recession (EC, 2009). Greece, Ireland, and Spain recorded relatively high growth rates, high inflation rates, and external deficits, while other countries, most prominently Germany, recorded low growth, low inflation, and external surpluses. Largely as a result of the expenditure collapse during the crisis, many of the former deficit countries today record small current account surpluses, but whether these can be maintained if and when growth picks up remains an open question (Tressel et al., 2014). A sustainable rebalancing process, it is frequently argued, requires the surplus countries to stimulate domestic expenditure and inflate wages and prices, and the deficit countries to moderate expenditure and deflate. There is no consensus about what is a just or economically sensible distribution of the burden of adjustment between surplus and deficit countries. In practice, deficit countries, stifled by debt, face financing constraints and are forced to adjust, whereas surplus countries hesitate to do so.[1] In this project we take as given that surplus countries should contribute to the rebalancing process, and ask

[1] Adjustment is "compulsory for the debtor and voluntary for the creditor" (Keynes in Skidelsky, 2010, p.174).

how much they can help to ease the burden of adjustment for deficit countries. We estimate the size of spillover effects from surplus countries to deficit countries.

The Bundesbank argues that Germany can contribute little to stimulate growth, increase employment, and improve trade balances in Southern Europe (Bundesbank, 2010). *Bilateral* trade flows tend to be small, because Germany trades with a large number of countries. A German expenditure boom, according to this argument, would diffuse in many directions and the spillover effects on income and employment in Southern European countries are bound to be small. We calibrate a multi-regional input-output model with data from the World-Input-Output-Database (WIOD) to scrutinize the Bundesbank's claim.

2 Expected Results

We expect to find larger spillover effects than those reported in EC (2012). The principal reason is that a closed model takes into account the endogenous response of household consumption to increased income, which is ignored in the EC study.

We expect to find severe heterogeneity across countries. The weak integration of Greece into European supply chains probably implies that spillover effects (e.g. from Germany to Greece) are small. Spain and Portugal are more integrated into European supply chains; the spillover effects are probably larger.

We expect to find that spillover effects of shocks to gross fixed capital formation are larger than spillover effects of shocks to public consumption.

3 Policy Implications and Relevance for IMK

The Bundesbank argues not only that expansionary policies are undesirable but also denies that Germany is able to contribute to the rebalancing process in the South. Yet if spillover effects turn out to be "large" in absolute size, Germany would be able to help the deficit countries. The results would lend support to the notion that Northern Europe and in particular Germany, in the common European interest, should run more expansionary policies.[2]

If spillover effects turn out to be "small", calls for expansionary policies in Germany would need to appeal to Germany's own interest. The accumulation of ever larger quantities of foreign securities may not be in the German interest, for it involves the "exchange of Porsches for Lehmann certificates", and this exchange creates exchange rate risk, valuation risk, and default risk. To aide adjustment and promote growth in the South, more responsibility would fall on policies that target economic activity in the deficit countries directly.

[2]The input-output model can say little about the nature and design of these policies (public investment programs and tax reforms, education and innovation policy, wage policy with a view to its macroeconomic effects, etc.).

References

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