Key insights from Asian Europe Economic Forum  
- Asia and Europe in Times of Global Change

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Introduction

At the 10th AEEF meeting in Berlin this year (2014), we discussed the recent developments in trade, growth, global governance and monetary policy in Europe and Asia.

After the slump in trade during the crisis, Asia’s trade volumes recovered quickly in 2010 and now remain well above pre-crisis levels, see Figure 1. However, the European Union (EU) and US have become less relevant as trade partners in consumption goods whilst intra-regional trade has become increasingly important. Nevertheless, EU trade volumes with Asia almost doubled from ten years ago and now represent around one third of its total trade. Several trade agreements have been established (Singapore, Korea) and others are being discussed (Japan, China (investment)). This trend towards trade liberalisation in both regions may potentially spur weak, post-crisis growth.

Figure 1. Asia’s trade with the world 1990-2012, US $ Billions

Source: UN Comtrade

1 We thank Olga Tshekassinn for supporting the drafting of this paper.
Although Europe as a whole is recovering, six EU countries, including Italy and Greece, are currently contracting. Overall growth in the Euro Area (EA) was still sluggish in the beginning of 2014, and the first quarter ended with the disappointing result of 0.9% annual growth. To promote growth, Europe must focus on lowering financial fragmentation, establishing an effective banking union, strengthening the single market, improving the functioning of the labour market and launching a Euro Area public investment programme.

Growth has also slowed down in emerging markets since the financial crisis. China stood at 7.4% in Q1 2014 compared to pre-crisis levels of over 10%, the lowest growth rate since 1990. It will need to counteract the slowdown in investment with an increase in consumption and address the vulnerabilities in the financial sector that have resulted in the outflow of capital to more developed economies with lower marginal returns. Also, China “needs to create more decent jobs to avoid a social crisis.”

In Japan, Abenomics has fostered the development of a more stable business atmosphere, with quarterly year-on-year growth rates of over 2% in the last three quarters. Overall, the main challenges for Asia lie in deepening regional integration in trade and investment and improving infrastructure and welfare systems. These issues need to be addressed in order to stabilise growth and curb escalating inequality.

Monetary Policy in Europe

Since the beginning of the crisis, the European Central Bank (ECB) took substantial action to resolve the original liquidity problem that was caused by the quasi-freeze of the interbank market and other short term funding operations. It lowered the policy rate significantly (from 4.45% to 1%), introduced main and long-term refinancing operations (MRO and LTRO) at full-allocation, and lowered collateral requirements. Moreover, the ECB lengthened the maturity of LTROs several times, from 6 months to 1 year and finally to 3 years. These measures helped to provide liquidity, but did not re-catalyse private sector lending that had been cut significantly since the beginning of the crisis. They resulted, yet, in a considerable increase of the ECB’s balance sheets, see Figure 2.

The current problem in the Euro Area, however, is not liquidity. Doubts about the integrity of the Euro zone seem to have vanished, the functioning of the interbank market is re-established and sovereign bond yields have fallen to low levels. The new, yet persistent problem is the falling rate of Euro Area annual inflation since the end of 2011. It dropped, surprisingly, to 0.5% in May and has carried over into June. Well below the ECB’s target of 2%, it is the lowest figure recorded since autumn 2010. Furthermore, drawing from core inflation statistics that exclude volatile food and energy prices, five (Cyprus, Greece, Portugal, Slovakia and Spain) of 18 Members have experienced outright deflation in the last few months.

What is more worrying is that inflation expectations have been falling since mid-2012 for both 2-year and 10-year maturities as shown in Figure 3. They seem to be de-anchored from target inflation over the medium-term: the 2-year ahead expectations are significantly below

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2 Fan He and Bin Zhang (2014)
3 Cleays, Darvas, Merler and Wolff (2014)
the target and are not expected to return quickly. Also, the long-term ahead inflation expectations started to fall recently, possibly due to the ECB’s inaction after its own medium-term inflation forecast fell below the target. As it became more likely that the fall in inflation was not a short-term phenomenon, agents started to revise their long-term expectations.

*Figure 2. Size of balance sheets of various central banks, in % of GDP*

Why is it problematic if inflation falls behind expectations? In order to restore the competitiveness of periphery EU countries, they must undergo an adjustment process that implies lower price levels relative to core countries. Hence their inflation levels need to be lower, or even negative, relative to the overall inflation rate. Consequently, the more EA inflation comes down, the more inflation levels in the periphery must fall. This development clearly imposes a risk on the sustainability of public debt and needs to be addressed by the ECB in a more concrete manner.

The package of measures announced by the ECB on 5th June 2014, including a cut in the main deposit facility rate to negative levels (-0.10%) and the introduction of targeted long-term refinancing operation (TLTRO), has been criticized for not going far enough. The package aims to address the issue at hand by easing the monetary policy stance, enhancing the transmission channel to the real economy, and bolstering inflation, but further measures are likely to be needed.

While the negative rate policy will probably have only minor effects, the effectiveness of the package depends greatly on the ability and willingness of the banks to restore lending to the real economy. How is the TLTRO different from the previous LTRO instruments? The main difference is that the targeted LTRO is conditioned on lending to corporations. Banks can lend up to 7% of their outstanding loans to the non-financial private economy as of April 2014 as initial allowances and additional amounts at a later stage if their net lending is above a certain benchmark that takes into account their lending activity in the 12-months period prior to the reference date. At both stages the rate will be fixed to the MRO rate plus ten basis points. And while the initial allowance will have a maturity of 4 years, the additional lending will mature after a shorter time. Details are still to be specified by the ECB.
Despite the fact that Euro area inflation is expected to remain low for a prolonged period of time, as noted by keynote speaker, Vitor Constâncio, Vice President of the ECB,⁴ “there is no evidence so far that economic agents are postponing expenditure plans, which is sometimes seen as an indication of deflation.” A comparison to the period of Japanese deflation is, hence, probably reaching too far.

**Monetary Policy in Asia**

Japan has been in a period of anaemic growth since the asset bubble burst in the early 1990s: a quickly aging population and rising welfare expenditure caused its already excessive public deficit to grow rapidly. After his re-election, Prime Minister Shinzo Abe launched ‘Abenomics’, a programme designed to revive the economy and boost Japan’s competitiveness. The “three arrows” of Abenomics comprise 1) fiscal consolidation, 2) monetary easing and 3) structural reforms. While the third arrow has yet to be addressed, several measures pertaining to the first two components of the programme have already been implemented.

The first step to monetary easing was made by setting an inflation target of two percent, measured by the year-on-year change of the CPI. The Bank of Japan (BoJ) conducted aggressive monetary easing to achieve this goal. Unlike during the previous legislation period of the government, the BoJ is not investing in short-term government bonds. Instead, it is focusing on longer-term maturities and increasing the monetary base.

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⁴ “We expect euro area inflation to remain low for a prolonged period.” (Vitor Constâncio, AEEF, Berlin, 15.05.2014)
Japan has a debt to GDP ratio of over 200%, much higher than countries like Greece or Italy. But its interest rate is around 1% and sustainability is maintained. This is due to the fact that most of its government bonds are held by domestic investors, and despite the high deficit, demand for bonds remains high. Banks, insurance companies, and pension funds are looking for safe investments and focus on government bonds instead of corporate loans, which are significantly riskier. Fiscal consolidation is, nevertheless, high on the agenda with regards to long-term sustainability, and the government has to increase revenues while cutting public spending. The former has already been addressed by an increase in tax on consumption from 5% to 8% as of April. Looking to the future, a reduction in government spending could be achieved through postponing the retirement age and by basing the wage system on productivity instead of seniority.

One of the main goals of Abenomics is to increase the share of stocks and bonds in households’ financial assets allocation because funds that could be used to finance credit-starved corporations are instead held as cash, deposits, and insurance. Most of Japanese assets are held by seniors whereas younger people have much less capital available. Wage growth has been sluggish in the last decade and housing and education costs weigh heavily on household budgets. A productivity wage system could hence assuage the problem and increase the amount of funds available to the younger population.

The third arrow, namely structural reforms, has yet to be fully implemented. Potential policies should stimulate an increased labour market participation for women, an enlargement of the share of government expenditure on education and R&D, the development of domestic consumption by an increase in the wage share, the implementation of agricultural reforms, and the facilitation of SME financing. These preliminary steps would boost Japan’s ailing economy.

A major criticism of the Japanese approach is the pace at which changes are implemented. In particular, there are doubts about the speed of implementation of the third arrow.

**China**

Unlike the other 4 major currencies (Japanese Yen (JPY), US Dollar (USD), Euro (EUR), British Pound (GBP)), the real effect of exchange rate of the Chinese Renminbi (CNY) is well above pre-crisis levels: it has appreciated 35% since 2007. The Yen appreciated initially but it then depreciated sharply after Abenomics was implemented in the beginning of 2013 (see Figure 4.). Consequently, beginning in 2014, all four major currencies dipped below their respective 2007 levels while the renminbi appreciated.

A look at the real policy rates (Figure 5) shows that China is also the only country to have a positive real policy rate. The Bank of England (BoE), Federal Reserve (FED) and ECB are in negative territory since 2010 and BoJ joined the club in 2013. Both the real policy rate and

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5 Yoshino and Hesary (2014)
6 Policy rate less CPI
the real effective exchange rate indicate that the PBC has maintained the tightest policy among the big five central banks following the global financial crisis” (Guonan Ma) 7.

Figure 4. Real effective exchange rates (January 2007 = 100)

The main questions that remain with respect to China are the speed of its capital account and interest rate liberalisation and how the two will interact. What will be the implications for international capital flows and for the Renminbi as an international currency?

Figure 5. Real policy rates of major central banks in %

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7 Bruegel blog post, 1st July, “How loose is China’s monetary policy?”
http://www.bruegel.org/nc/blog/detail/article/1375-how-loose-is-chinas-monetary-policy/
Source: Datastream, Note: real policy rates are defined as policy rates less CPI inflation. The PBC policy rate is the official one-year deposit rate.

Conclusion

Trade and economic linkages between Asia and Europe have strengthened over trade and economic relations. Structural reforms must be adopted on both sides to make the recovery more sustainable and make economies more resilient to global economic challenges. In monetary policy, we have seen different approaches across Asia, Europe and the US. While the US is leading the charge out of the recession, the Euro Area is behind the curve, Japan is taking a more aggressive course of action via Abenomics, and China is on a different path with a conservative monetary policy and appreciating currency.

References


Fan He and Bin Zhang, “Can structural reform boost economic growth?”, conference background paper for the AEEF (2014)
