Euro Area: Stable Destabilization?

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Economics & Management

General assessment

- A clear and lucid analysis of one of the *symptoms* of eurozone gloom: the switch to a strong current account surplus since 2011
- Lucidity of the positive analysis yields to *obfuscation* when it comes to point out the responsability of policy makers
- *Wishful thinking* pervades the normative analysis ("Good and Bad Ways to Achieve External Rebalancing", p. 87ff)
- Whither *deflation*?

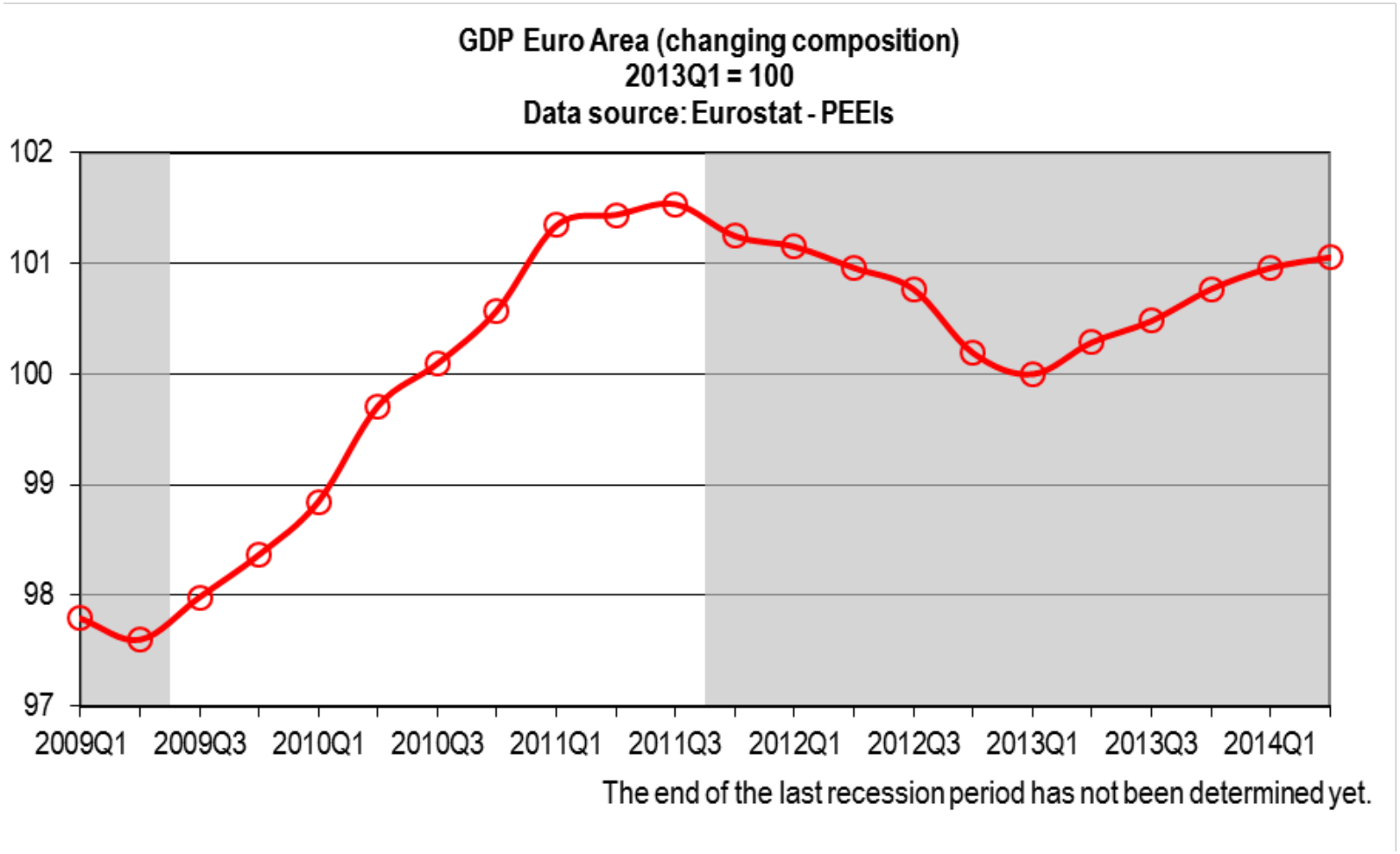
SYMPTOMS

The IMF key points rephrased less diplomatically

1. Current account imbalances have narrowed **since 2011 because the Euro area entered a policy-induced, double-dip recession late that year.**
2. Adjustment has been asymmetric **because activity in crisis countries has dipped harder and deeper.**
3. Demand contraction—as opposed to relative price adjustment—has been the main driving factor **in sharp contrast with the US which has been in expansion since June 2009.**
4. The adjustment is expected to be durable **if the current policy stance is maintained**; but much depends on underlying view of potential output/output gap **and on hysteresis in labor markets.**
5. Both country-specific and area-wide policies are important to advance the adjustment within the euro area. **Yes, indeed, but which ones?**

UNDERLYING DATA

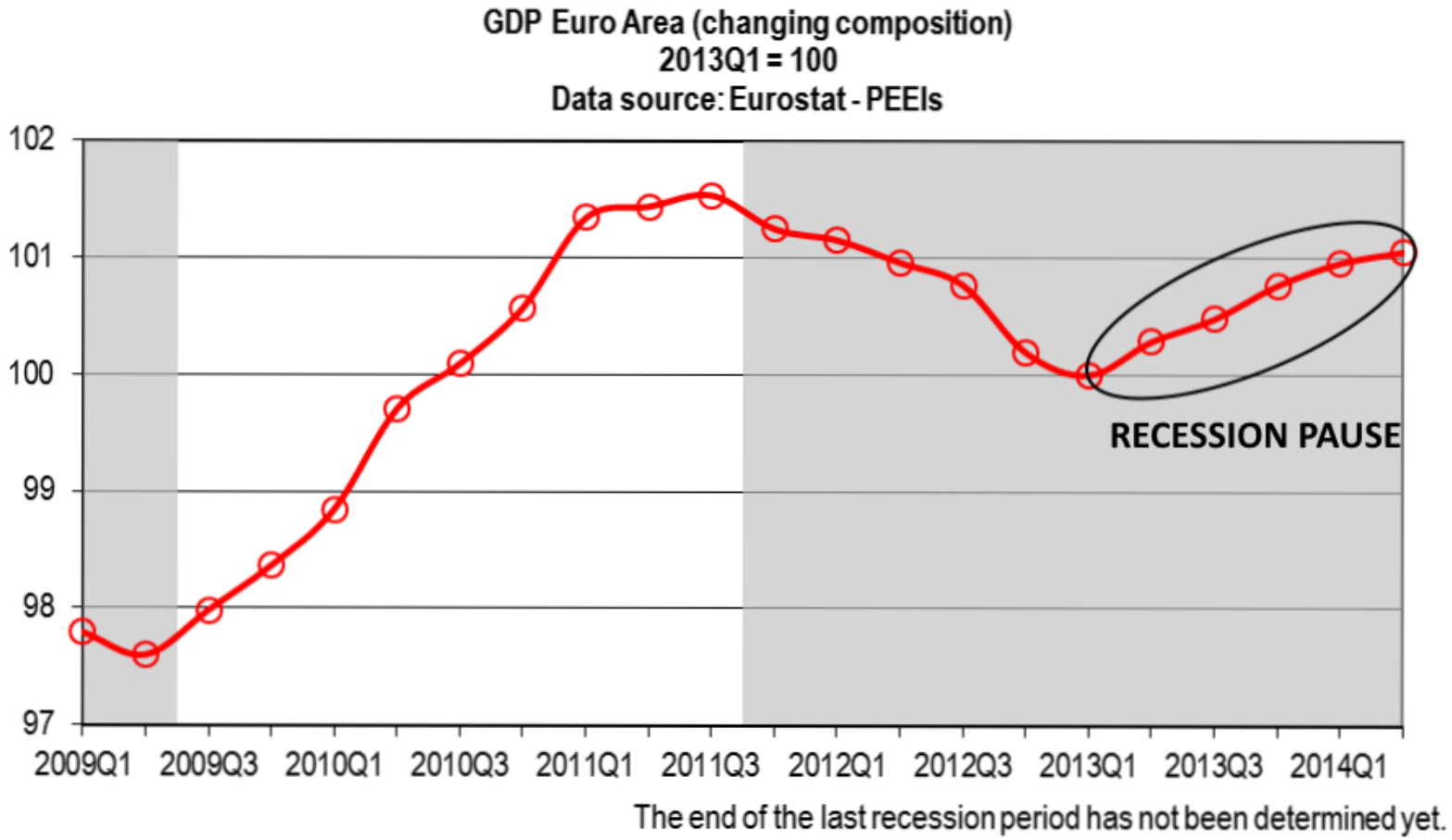
GDP since 2009



Grey bands: CEPR Euro Area Business Dating Committee

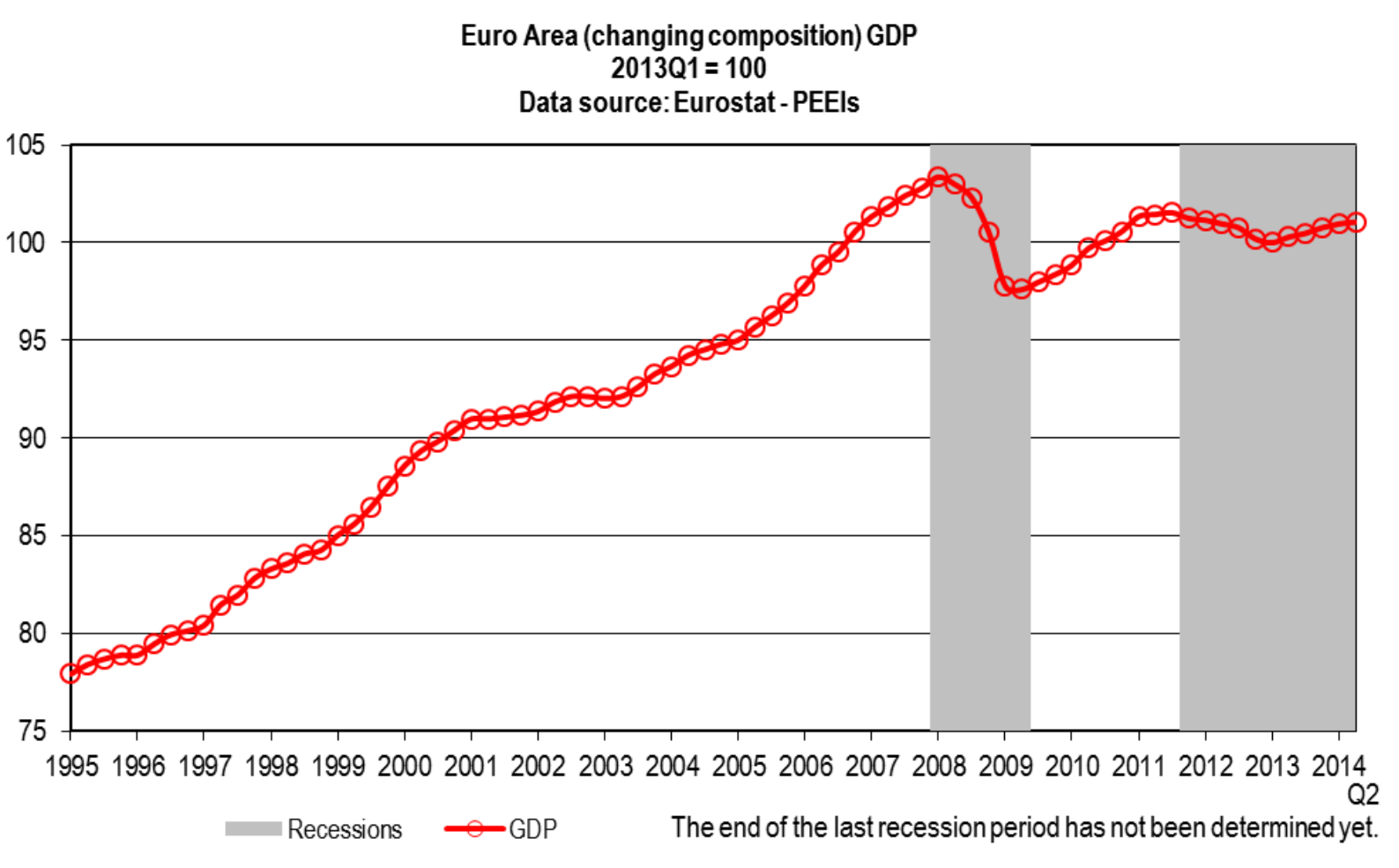
A “recession pause” since 2013Q1

Five quarters of measly growth an expansion do not make!



GDP since 1995

2009Q2-2011Q3 is clearly an expansion: double-dip after 2011Q3



Wishful thinking

- IMF, EC, ECB or OECD have not seen, or have taken a long time to see, or refused to see that the recession that started in 2011Q3 did not end in 2013:
  - IMF: "*The euro area is turning the corner from recession to recovery*" (Jan. 2014), "*Advanced European economies are expected to resume growth in 2014*" (Apr. 2014), *For the euro area, risks surrounding the growth projection are tilted to the downside.* (Oct. 2014)
  - EC: "*Recovery gaining ground*" (Feb. 2014), "*Growth becoming broader-based*" (May 2014)
  - ECB: "*Economic recovery gradually taking hold*" (Draghi, Feb. 2014), "*Eurozone recovery is on track*" (Draghi, 7 Aug. 2014), "*The recovery is losing momentum*" (Draghi, 22 Sep. 2014)
  - OECD: "*Economic activity is projected to continue to recover as confidence improves further*" (May 2014), "*Moderate global growth is set to continue, but weak demand in the euro area remains a concern*" (Sep. 2014)

POLICY RECOMMENDATION

It looks quite easy according to the IMF (p. 80ff)

- **The doctor's prescription**
  - "Substantial progress" in reforming product and labor markets
  - A small fiscal expansion in the Netherlands (.25% + .25% of GDP over two years)
  - A public investment increase in Germany(.5% + .5% of GDP over two years)
- **The expected improvement**
  - 2 to 6% cumulative rise in German GDP by 2019 over the baseline
  - 3.5% cumulative rise in Euro area GDP by 2019 over the baseline

Good rebalancing

Table 5. A Desired Rebalancing Scenario [1/]

Economy	Real GDP	Inflation [2/]	Real Investment	Real Exports	Real Imports	Current Account[2/]	Real Competitiveness Index [3/]
Germany	6.4	0.9	15.9	5.0	5.8	-1.9	-1.7
France	1.7	0.5	-0.3	3.2	-2.4	0.7	-3.9
Italy	2.1	0.5	0.8	2.5	-2.2	0.6	-3.1
Spain	2.2	0.6	1.7	2.7	-2.4	0.9	-3.2
Greece	2.1	0.9	4.7	2.8	1.6	0.0	-0.6
Ireland	2.8	1.0	2.8	3.6	2.3	-1.2	-1.7
Netherlands	3.3	0.9	8.1	3.3	2.7	-0.7	-1.4
Portugal	1.9	0.7	3.1	2.0	1.3	-0.4	-2.0
Euro area	3.5	0.7	6.3	3.5	1.1	-0.2	-2.4
Memo:							
United States	0.1	0.0	0.2	0.6	0.9	0.0	1.2
United Kingdom	0.5	0.1	0.5	1.2	2.1	0.1	0.8
China	-0.1	0.0	-0.3	1.0	0.6	0.1	0.7

Sources: EUROMOD, IMF Research Department and OECD.
1/ Percent deviation from the April 2014 WEO baseline for 2019, unless noted otherwise.
2/ Percentage point deviation from the April 2014 WEO baseline for 2019.
3/ Measured by percent changes in REER relative to the April 2014 WEO baseline for 2019, where negative indicates real depreciation.
Note: This scenario assumes that all economies advance structural reforms to close 10-20 percent of their gaps relative to the best practice of the latest OECD structural reform indices on product and labor market institutions. Structural reforms are assumed to be persistent. The scenario further assumes that public and private investment in Germany each increase by 1 percent of GDP, and the Netherlands loosens their fiscal stance by 1/2 percent of GDP. These additional impulses are assumed to be spread over two years (2014 and 2015). The model also allows for positive productivity spillovers from Germany to the rest of the euro area.

(Selected Issues, art 4, p. 87)

If it sounds too good to be true, it probably is

1. Structural reform: important, but slow results and maybe optimistic to imagine that by 2009 "all economies advance structural reforms to close 10-20 percent of their gaps relative to the best [OECD] practice."
2. Doubtful spillover effects are that strong – it looks like the assumed German multiplier is very high.
3. Even if spillovers are strong, the cumulative rise in GDP outside Germany is less than 2% *over 5 years* – hardly enough to prevent Syriza or Front National from making inroads into power.
4. Last but not least, to maximize spillovers, money should be spent in the largest economies where the multiplier is highest, not the lowest: i.e., probably in France or Italy rather than in Germany!
5. Show by comparison the effect of a public investment increase of .5% + .5% of GDP over two years in **France**, and in **Germany and France.**

Three commandments of multipliers

1. Coordinated expansions thou shalt engineer
2. Counter-cyclical multipliers thou shalt (optimally) exploit over time
3. Counter-cyclical multipliers thou shalt exploit across (desynchronized) countries

CONCLUSION

- If table 5 depicts the *good* rebalancing scenario, then the euro area will remain in a "recession pause" for the time to come (stability)
- It's more likely France will take Germany into a downward spiral (destabilization)
- Have we reached the point where "depress-thy-neighbor" is the best hope for a euro area policy change?

Food for thought

The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom (J. M. Keynes, General Theory, p. 322)

Supplementary material

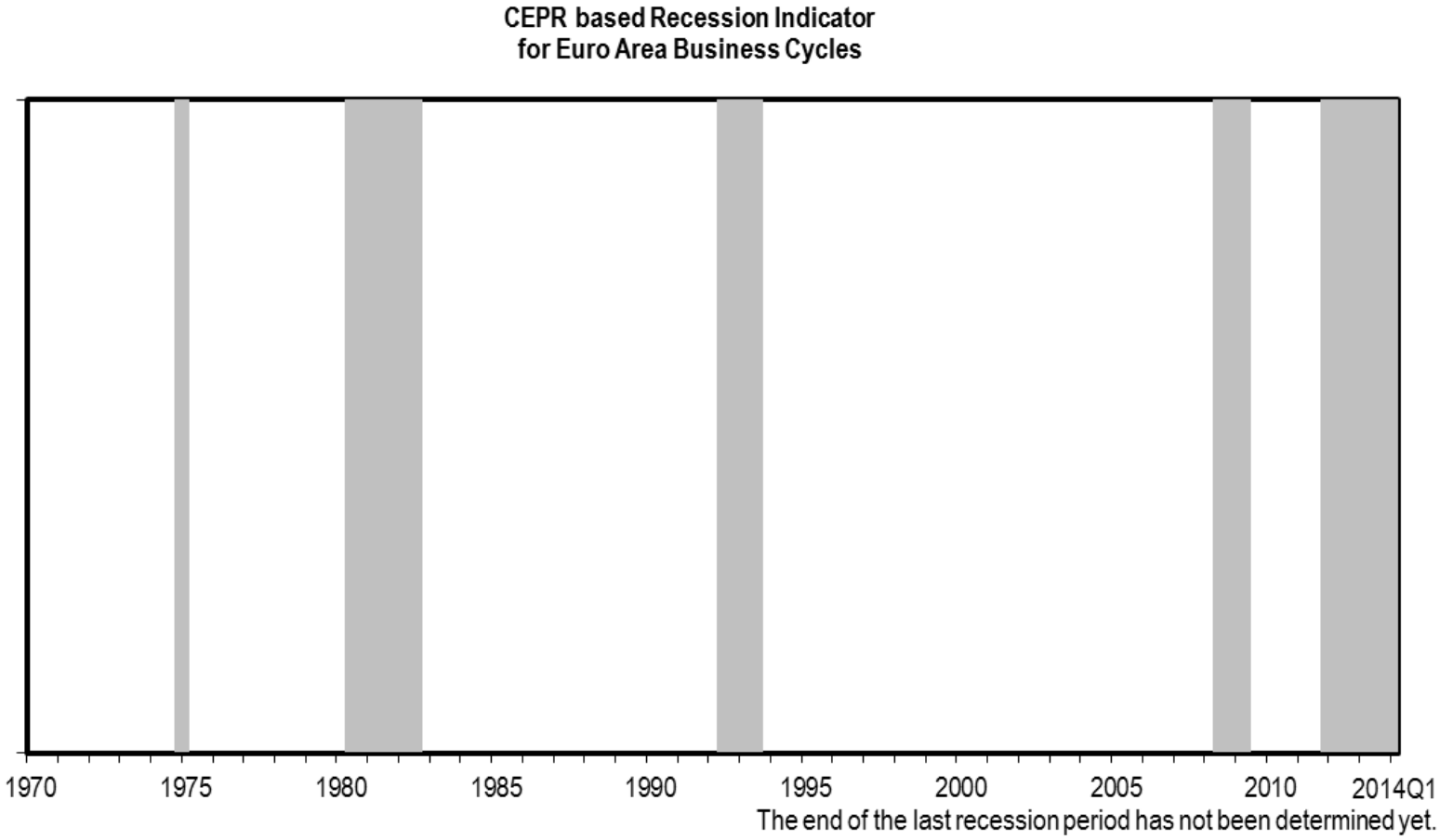
1. More data

Calendar of turning points

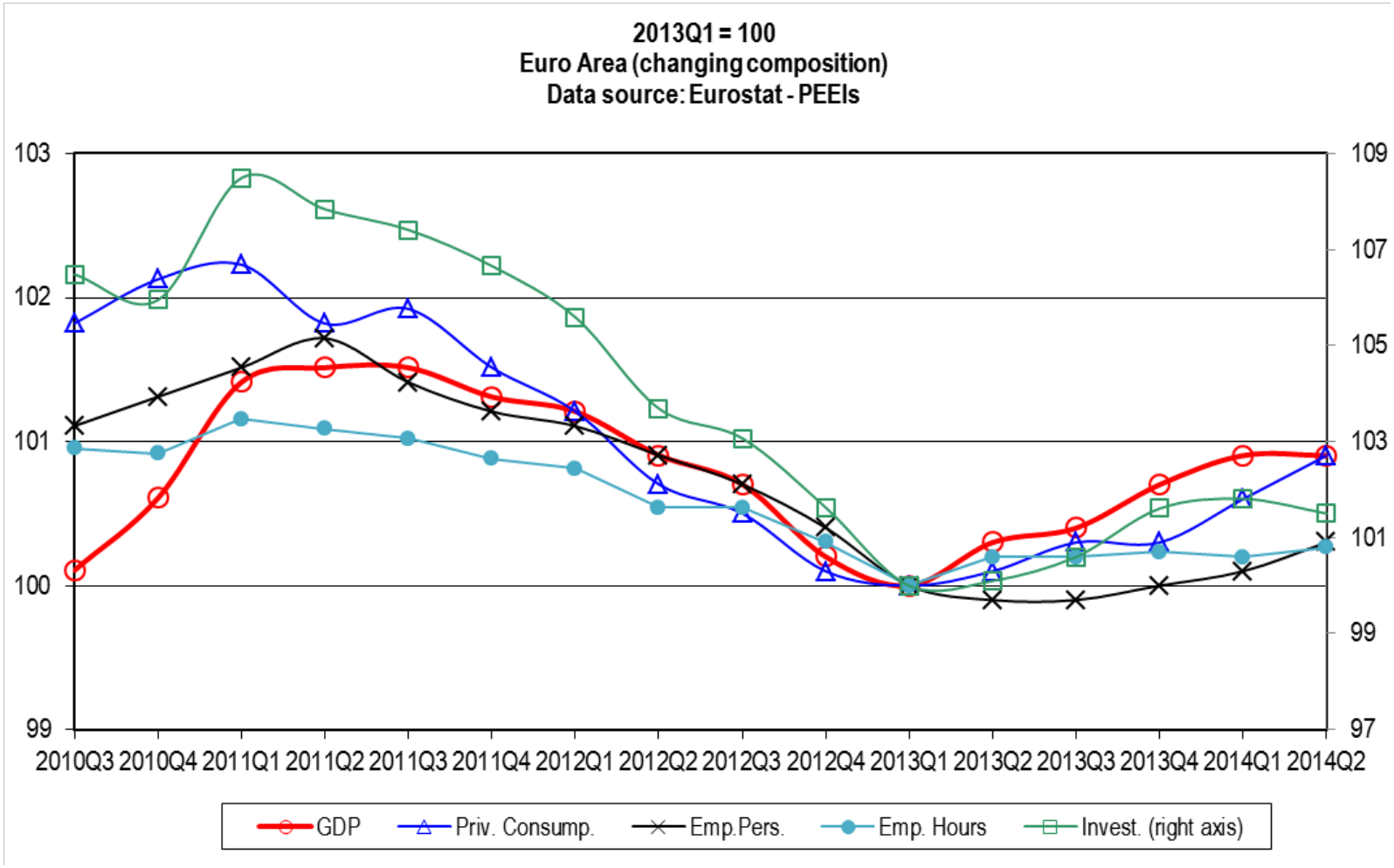
Table 1. Peaks and Troughs

Date	Peak/Trough	Announcement Date
2011Q3	Peak	15 November 2012
2009Q2	Trough	4 October 2010
2008Q1	Peak	31 March 2009
1993Q3	Trough	22 September 2003
1992Q1	Peak	22 September 2003
1982Q3	Trough	22 September 2003
1980Q1	Peak	22 September 2003
1975Q1	Trough	22 September 2003
1974Q3	Peak	22 September 2003

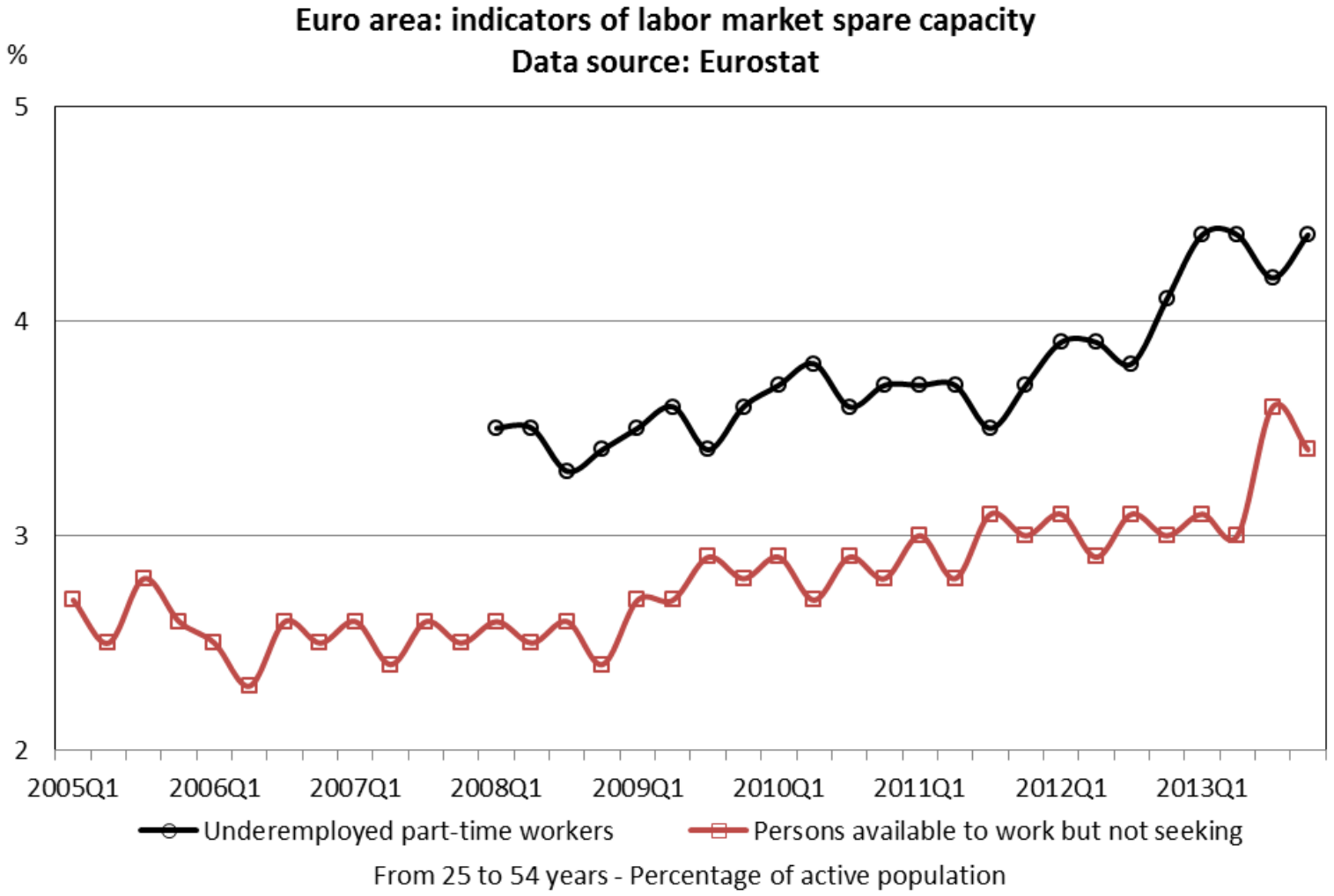
Grey bands


CEPR based Recession Indicator
for Euro Area Business Cycles
1970
1975
1980
1985
1990
1995
2000
2005
2010
2014Q1
The end of the last recession period has not been determined yet.

Components of GDP and employment

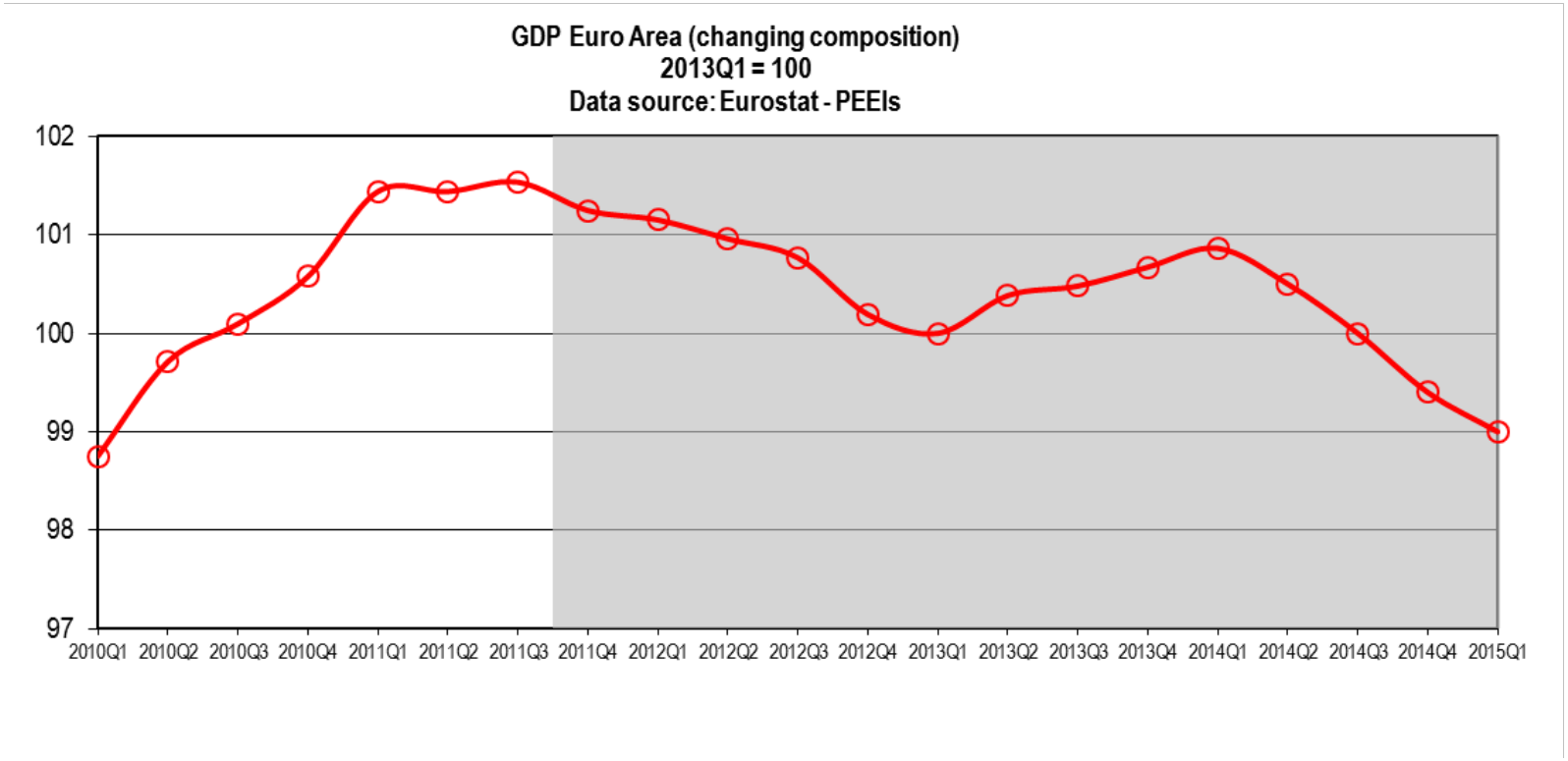


Indicators of underemployment



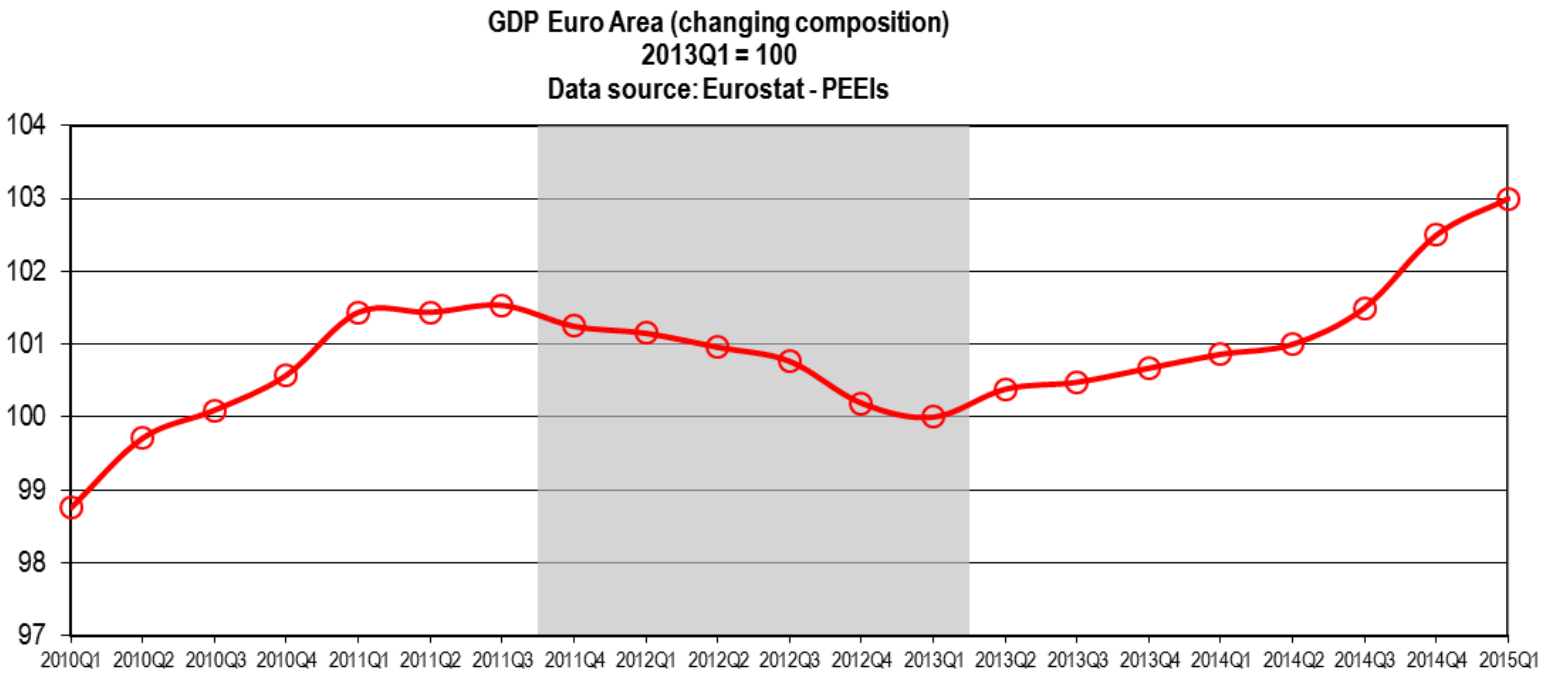
2. What's next?

Long recession with a pause



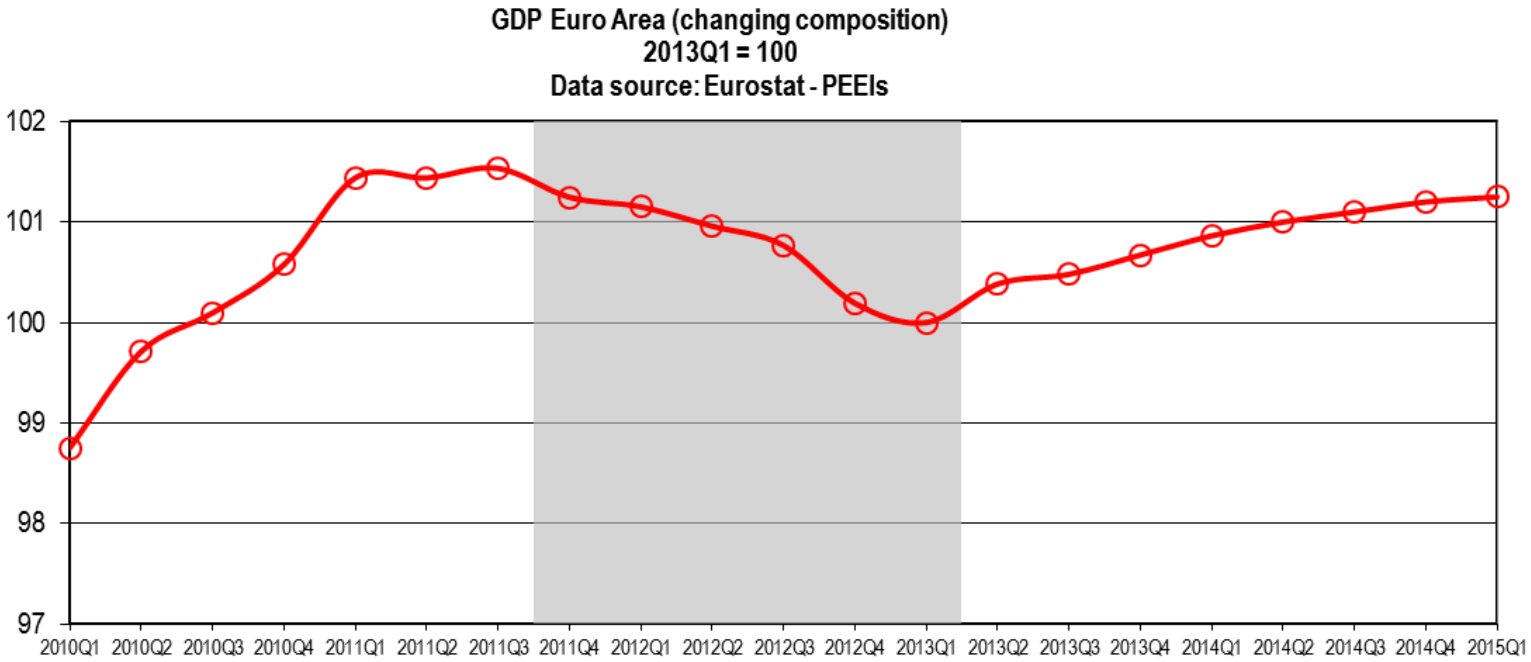
Continuation of the double-dip recession that started afer 2011Q3, not a third, distinct, triple-dip recession

Significant expansion with a slow start



Then we will likely call 2013Q1 a trough

Long but feeble expansion



Muddling through, "new normal," stagnation: not good news!