Market Insight

Prospects for Economic Recovery in the Euro Zone

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Recent events in Greece highlight the euro zone's continuing troubles and feeble economic recovery. They also reveal the failure of austerity policies in most peripheral countries, particularly Greece. Austerity has not worked in the past five years, is not working now and will not revive growth in the future. Instead, the euro zone needs economic policies that will foster growth, create jobs and increase effective demand. This will require such initiatives as proper public expenditures, lowering taxes, raising labor productivity, curbing inefficiency and reducing political corruption in the peripheral countries.

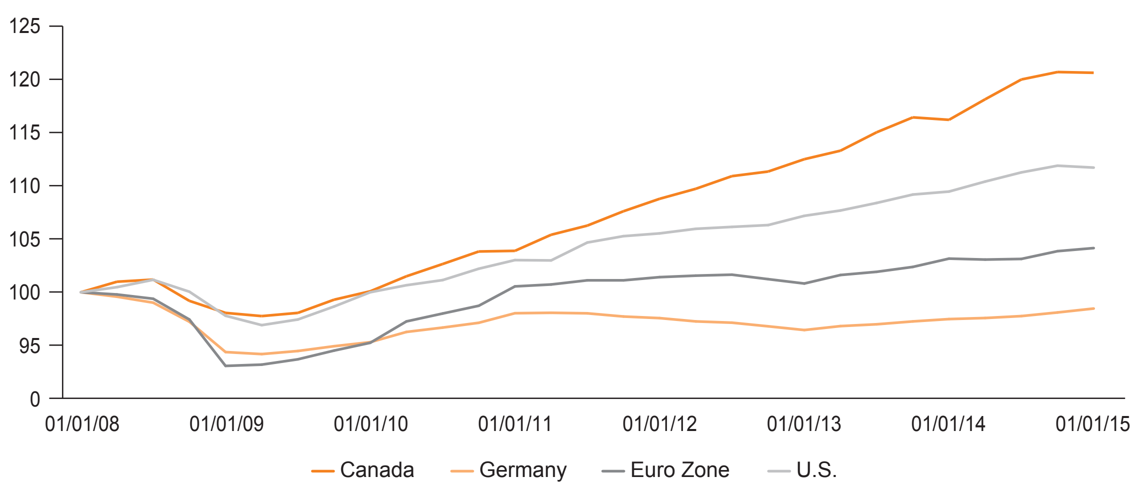
This article assesses the euro zone's current economic conditions, the institutional flaws that have led to the currency bloc's problems, the reasons for low or negative nominal interest rates among euro zone government bonds, downside risks to the prospects of recovery and alternatives to austerity.

Feeble Recovery With Few Bright Spots

Economic recovery in the euro zone continues to be weak. Real GDP in the euro zone is still around its pre-crisis level, whereas real GDP in the U.S. and Canada have fared relatively better (Figure 1). The pace of growth is disappointing and will probably be only about 1% in 2015. The consensus among forecasters of around 1.5% growth strikes this analyst as overly optimistic. Previous forecasts generally have been more optimistic than actual growth in the euro zone. There is little reason to think they will be right this time!

Figure 1. Real GDP in the Euro Zone has Remained Low Since the Global Financial Crisis, Particularly Compared to the United States and Canada

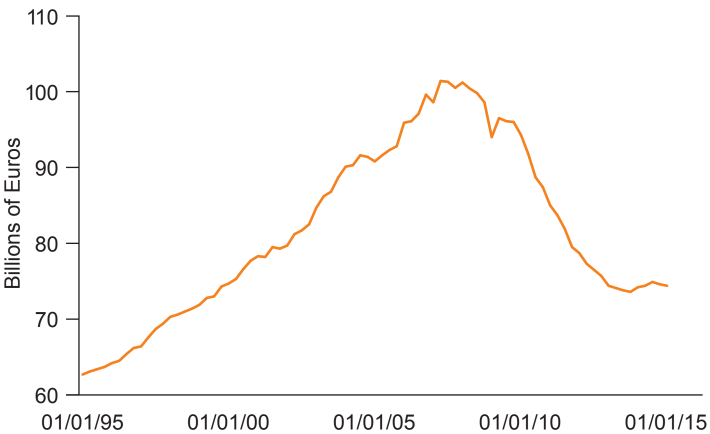
Indexed Real GDP Levels, 01/01/08=100



Source: Macrobond

Germany is generally hailed as the euro zone's success story. Its unemployment rate is low and has declined since the end of the global financial crisis. But as shown in Figure 1, German GDP has grown only modestly during this period. What's more, Germany's failure to pursue an expansionary fiscal policy and its current account surplus have worsened the euro zone's woes. France's performance has been dismal, and Italy has not yet recovered. Spain's economy bottomed out only in 2014; it is finally beginning to grow after many years of recession. Greece has experienced a catastrophic decline in real GDP (Figure 2); its prospects for recovery remain bleak. Job and income growth are still weak throughout the euro zone.

Figure 2. Greece's Real GDP Has Declined Severely Since 2008



Source: Macrobond

Greece: Case Study in Misguided Policy

The turmoil in Greece and the euro group's handling of the matter illustrate a lot that is wrong with the euro zone. In a recent assessment of Greece, the International Monetary Fund (2015) bluntly states that "Greece's debt can now only be made sustainable through debt relief measures that go beyond what Europe has been willing to consider so far."[1] This suggests that austerity policies not only have failed to stabilize Greece's elevated debt but have plunged the Greek economy into an abyss. CNBC commentator Daniel Alpert (2015) recently observed that the bailouts have primarily benefited financial institutions, particularly those German, French and other European banks that are able to transfer their holdings of periphery debt to the European Central Bank and other public institutions. Alpert convincingly argues that euro group policies have been "socializing Greece's bad debt and placing taxpayers throughout the euro zone at risk of sharing the losses thereon."[2]

Yanis Varoufakis (2015), Greece's erstwhile finance minister, observed: "To prevent a default on fragile French and German banks, that had irresponsibly lent billions to irresponsible Greek governments, Europe decided to grant Greece the largest loan in world history on condition of the largest ever magnitude of fiscal consolidation [austerity] which, naturally, resulted in a world record loss of national income — the greatest since the Great Depression."[3] The ECB may have done this to protect the euro zone financial system and ensure stability, but what will be done to restore demand in Greece and elsewhere? Euro zone authorities, particularly German policymakers, appear to be entrenched in the economics of austerity.

[1] IMF (2015). "Greece: An Update of IMF Staff's Preliminary Public Debt Sustainability Analysis," IMF Country Report No. 15/186, July 14, 2015

[2] Alpert, Daniel (2015). "Greece's Creditors Need a Wake-up Call", CNBC, June 30, 2015

[3] Varoufakis, Yanis (2015). "The Defeat of Europe," *Le Monde diplomatique, English Edition* (August)

Despite Policy Missteps, Signs of Progress

Despite the bleak outlook there are signs of ongoing if feeble recovery: consumption growth has recovered in recent quarters and bank lending activity has improved slightly, albeit after years of stagnation. Purchasing manager surveys in Germany, France, Italy and Spain suggest manufacturers have been seeing improvements in 2015. However, industrial production, a leading indicator of economic activity, is still slightly below 2008 levels, even for Germany; it is notably lower for France and Italy.

Consumer spending in the euro zone has improved. Real retail sales have picked up since the beginning of the year, though they remain markedly below their 2007 peak. New-car registrations, an indicator of auto sales, have risen since 2013. Consumer angst has subsided, and confidence has gradually improved for the past three years. Nonetheless, sustaining even moderate growth in consumer spending will be challenging, given a weak labor market, muted real income and real wage growth and unfavorable demographics.

Euro Zone Still Faces Serious Challenges

Business investment in the euro zone has been weak since the financial crisis. The level of investment is low, and business confidence has yet to show strength. The weakness of business fixed investment bodes ill for growth and productivity gains going forward. Concurrently, lending by banks and borrowing by non-financial corporations has been weak since the onset of crisis. In recent quarters, there has been a slight recovery in borrowing by nonfinancial corporations. Demand for credit has risen, while bank credit standards have been relaxed slightly.

The euro zone has current account and trade surpluses, but export growth is still tepid while imports have been flat. Though the euro has weakened, it has not benefited exports much. Potential benefits for export growth seem further limited by the soft global economy. The euro zone's key trading partners other than the U.S. — Japan, other European countries and emerging market nations — are still growing only weakly themselves. What's more, a moderate pickup in exports will not be enough to offset continuing weakness in domestic demand.

Between late 2008 and 2013 the euro zone shed nearly five million jobs. Since then job growth has been weak, leaving the unemployment rate high. Unemployment in the peripheral countries is troublingly high, particularly for youth. By contrast, Germany's unemployment rate has declined since the financial crisis. There has been no effort to create jobs through public works programs or joint efforts with nongovernmental civic organizations. Unless other countries can begin to create jobs, the euro zone unemployment rate will remain high.

Though less severe than in the recent past, deflationary pressures persist as evidenced by quite low rates of inflation and muted inflationary expectations. The euro zone economy is likely to remain mired in low inflation for some time to come. The consensus expectation among forecasters is for just 0.2% inflation this year. The euro zone rate of inflation will fall markedly below the ECB target rate of slightly below 2%. It is unlikely that the euro zone economy will achieve this inflation target rate anytime in the coming two to three years.

Feeble growth, weak demand, labor force slack, austerity measures that cut public spending and increase taxes, and low energy and commodity prices have pushed down the rate of inflation across the euro zone. Forecasters expect the actual rate of inflation to undershoot the ECB's target one year and two years ahead. Long-term inflation expectations have not budged much. But if observed inflation continues to stay low, long-term expectations could become unanchored. Consumers' inflation expectations have been dwindling. The soft growth in unit labor cost will keep inflationary pressures limited.

Euro Zone Institutional Flaws and the Origins of the Crisis

The euro zone's institutional structure was flawed from the onset and remains so. The separation of monetary policy from fiscal policy makes it challenging for euro zone countries to conduct countercyclical policies. Investors demand a risk premium on government debt when the ratio of debt to nominal GDP increases due to rising fiscal deficits (net public sector borrowing). Therefore, euro zone countries must depend on the ECB to keep government bond yields low — and to limit their interest rate spreads with respect to Germany — through low policy rates, large-scale asset purchases and other actions. Yet the euro zone's institutional foundation is quite restrictive and the ECB's legal and political mandate is largely confined to maintaining its inflation target. The treaties and statutes that define the ECB's mandate mostly ignore issues of monetary-fiscal coordination, countercyclical policies and financial stability. Measures such as monetary financing, privileged access of financial institutions and bailouts are prohibited. Others, such as fiscal provisions on government deficits and levels of fiscal deficits and government debt, are strictly limited.

Perceptive analysts commented on the euro zone's flawed institutions right from the start. Wynne Godley (1997) wrote: "[I]f a government stops having its own currency, it doesn't just give up 'control over monetary policy' as normally understood… its expenditures can be financed only by borrowing in the open market and this may prove excessively expensive or even impossible, particularly under 'conditions of extreme emergency.'[4] Christopher Sims (2012) identifies three problems: the absence of "essential fiscal backing" for the central bank, the rigid fixation on inflation target and the lack of a lender of last resort. Sims, however, is optimistic that these institutional problems can be fixed.[5]

Prelude to Crisis: A History of Inefficiency

From the creation of the euro up to the financial crisis of 2008, unit labor costs in the peripheral countries rose sharply. In contrast, unit labor costs in Germany remained fairly contained. Labor productivity in the peripheral countries was notably lower than in Germany, especially in Greece and Portugal. Government debt ratios in Greece, Italy and Portugal rose sharply and became quite elevated. The private sectors of Spain, Ireland, and Portugal were also highly leveraged and thus vulnerable to shocks, particularly Spain and Ireland, which had experienced massive housing bubbles. Domestic private balances deteriorated in a number of peripheral countries as asset prices tumbled. Peripheral countries such as Greece, Portugal and Spain ran persistent current account deficits. What's more, Greece, Spain and Ireland had large fiscal deficits. In contrast, Germany ran very low deficits and a current account surplus. Indeed, Germany's low fiscal deficit became a problem for rest of Europe.

Despite years of austerity, elevated ratios of debt to nominal GDP remain big problems today for most peripheral countries. Indeed, all peripheral countries have seen their debt ratios rise in recent years as economic activity has slowed and reduced revenue collections, and as public expenditures have risen due to automatic stabilizers and discretionary measures. In Ireland, public debt also rose as the government was forced to assume responsibility for financial institution debt. Since the financial crisis the current account deficits of Spain, Portugal and Greece have disappeared, mainly because imports collapsed as their economies slowed. Ireland now runs a large current account surplus. Germany and the Netherlands had current account surpluses before the crisis; since then, their surpluses have increased, partly due to slower import growth but also because the weaker euro has boosted their exports.

[4] Godley, Wynne (1997). "Curried Emu — The Meal that Fails to Nourish," *Observer* (London), Aug 31, 1997, page 24

[5] Sims, Christopher (2012). "Gaps in the Institutional Structure of the Euro Area," in Public Debt, Monetary Policy and Finanical Stability, Banque de France, June 9, 2012

Consequences of Low and Negative Nominal Interest Rates

Nominal interest rates on government bonds of various maturities are extraordinarily low or even negative for several euro zone countries, including Austria, France, Germany and the Netherlands (Figure 3). Yields on peripheral country bonds rose sharply between 2010 and 2012; they began to decline in 2013 after the ECB undertook a wide range of measures that underscored its commitment to keeping the euro system intact.

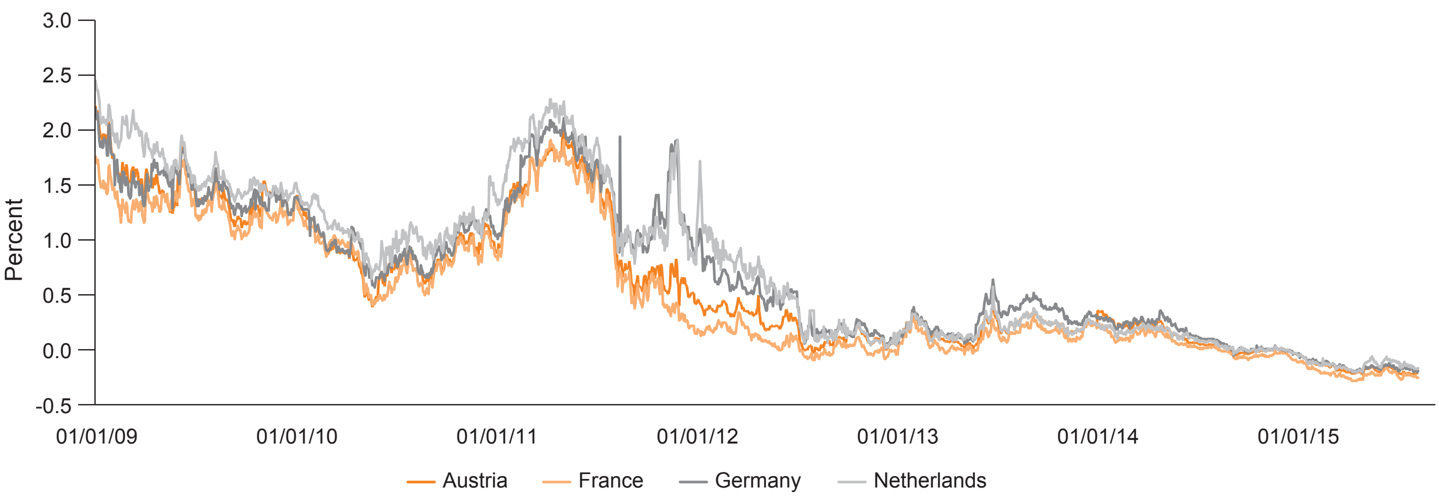
Since late 2013 government bond yields in many euro zone countries have been very low and even negative. There are many reasons for this phenomenon:

- The ECB's policy rates are either low (in the case of the main refinancing rate and marginal lending rate) or negative (deposit rate).
- The ECB has undertaken a variety of monetary policy actions, including ongoing and planned asset purchases, that exert downward pressure on government bonds' nominal yields.
- Low inflation, muted inflationary expectations and risks of deflation have reduced yields.
- The pace of economic activity is still feeble.
- Other advanced countries such as the U.S., U.K., Japan, Canada and Switzerland also are experiencing low long-term interest rates.

While the U.S. and the U.K. may hike their policy rates in coming quarters, rates in other advanced economies are likely to remain low. Low short-term rates in the major advanced countries have dampened government bond yields in several euro zone countries, particularly those that are considered safer than the peripheral countries.

Figure 3. Nominal Yields Have Become Negative on Certain Euro Zone Government Bonds

Nominal Yield, Two-Year Government Bonds

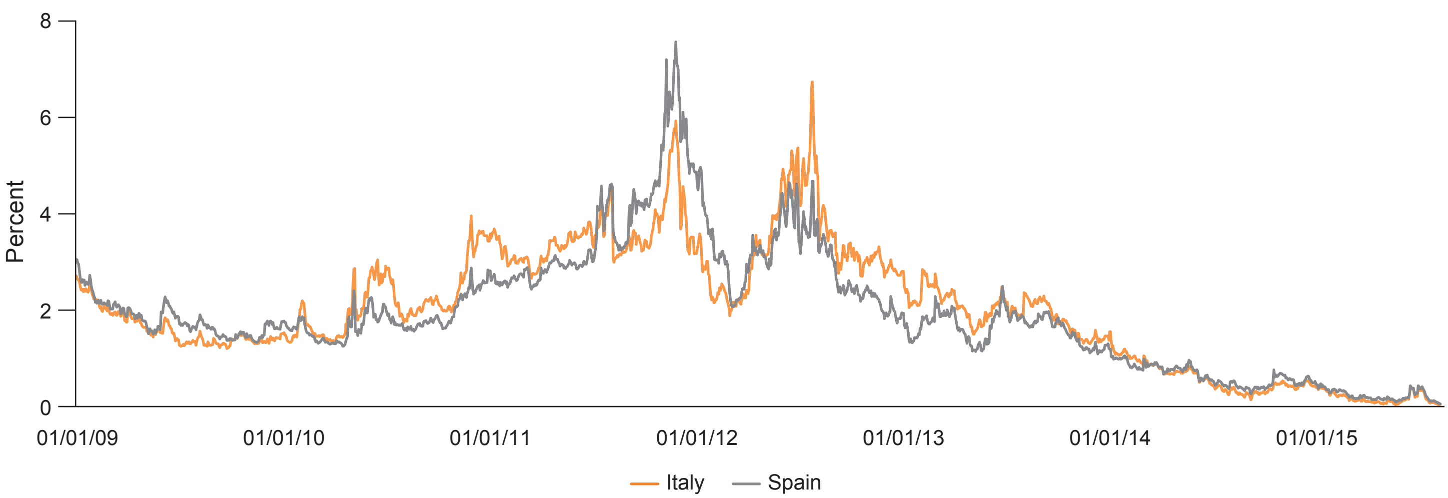


Source: Macrobond

Interestingly, even during the recent Greek turmoil, the government bond yields of Italy and Spain stayed low (Figure 4). This suggests that fears of Greek default did not spill over, probably because the ECB actions outweighed concerns about Italy's high debt ratios or Spain's fiscal challenges; also, the economic factors identified above served to limit yields. On the other hand, Greek bond yields remained elevated and spiked further during the turmoil (Figure 5).

Figure 4. Fears of Greek Default Have Not Impacted Spanish and Italian Government Bond Yields

Nominal Yield, Two-Year Government Bonds



Source: Macrobond

Figure 5. Greek Government Bond Yields Are Still Elevated

Nominal Yield, Ten-Year Greek Government Bonds

Source: Macrobond

Recovery Prospects: Downside Risks Ahead

While there are many risks to recovery in the euro zone, the most salient need at this juncture centers on the willingness of policy makers to tackle pragmatically the underlying economic issues.

Foremost are the risks of faltering effective demand and pronounced deflation, as domestic demand and exports remain soft. It is fairly clear that the euro zone is destined for years of feeble growth, even though it may benefit from of lower energy and commodity prices and a weaker euro. But without greater public spending, lower taxes and measures to create jobs, GDP growth will be limited. Long-term demographics — aging populations and low fertility rates — are unfavorable in the major euro zone countries. (France is an exception due to its higher fertility rate.) Unfavorable demographics imply that working-age populations and labor forces will shrink in coming years. At the same time, lack of investment in capital stock means slower labor productivity growth ahead, worsening the negative effects of labor shortage.

Finally, the new bailout program has averted for now the exit of Greece from the euro zone, but an exit cannot be ruled out in the future. The current bailout program will not foster growth in Greece — it seems to be more of the same austerity measures that have already harmed the country. In fact, the Greek economy could worsen due to cuts in public spending and higher taxes. Nevertheless, despite recent turmoil the euro zone framework should stay intact — at least in 2015!

Alternatives to Austerity

Sanjay Reddy (2015) argues for more inclusive and growth enhancing alternatives to austerity: “The real debate is nowhere near to taking place. The ultimate stakes are about the future of an economic and social order and not merely about a few bounced cheques, ‘moral hazard’ or financial contagion in the Eurozone.”[6] In his opinion, a more inclusive alternative would emphasize not merely more robust demand but investing in the productivity of all Europe, including its weakest countries, and more equitable sharing of risks and rewards.

If the euro zone is to restore growth, it will definitely have to seek alternatives to austerity. The flaws in the current institutions, as identified in Godley (1997) and Sims (2012), need to be corrected. The ECB’s actions and bailouts have largely benefited financial institutions, while providing little discernable impetus to growth.

The ECB’s actions need to be supplemented by the creation of euro zone institutions that can conduct countercyclical fiscal policies and take measures to support effective demand. The euro zone needs to institute public employment programs as well as public-private efforts to reduce elevated unemployment in many economies. The authorities should also undertake public investment to improve infrastructure. Taxes are quite high throughout the euro zone and high value added taxes (VATs) are highly regressive. Raising VAT rates in peripheral countries is harmful; there is no good reason for the authorities to raise VAT rates even higher! Rather, in countries like Greece there should be more of an effort to collect taxes and prevent tax evasion. Asset sales and privatization of state-owned enterprises in the middle of a recession often amount to fire sales at public expense. It is true that privatization can often raise efficiency, but the experience of privatization in transitional and developing countries shows the need for caution.

The main thrust of policies in the euro zone should be directed to raising effective demand. There is also a strong need to curb political corruption, inefficiency and cronyism in Greece and elsewhere in the euro zone, and to reduce regulations that protect vested interests and stifle businesses formation and growth. There are many examples of business regulations in the euro zone that do not help consumers at all.

Germany’s leadership role in the euro zone should come from its willingness to pursue countercyclical fiscal policy and to create strong European institutions that foster prosperity and solidarity among euro zone nations. Germany should shun the failed policies of economic austerity.

Conclusion

The euro zone’s plight could change quickly but only if policymakers implement viable alternatives to austerity. If they do not, the euro zone economy will at best experience a feeble recovery, which will be characterized by high unemployment. Meanwhile, interest rates on long-term government bonds of euro zone countries such as Germany, France and the Netherlands will remain low due to low ECB policy rates, quantitative easing, subdued inflationary pressures, low inflation expectations, the feeble pace of economic activity and investor flights to safety. If Greece continues to be subject to severe austerity, then the euro zone’s bailout is destined to fail.

[6] Reddy, Sanjay (2015). “Greece and the Eurozone: The Real Stakes,” reddytoread.com, July 12, 2015

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