The Elusive Recovery

Georg Feigl, Markus Marterbauer, Miriam Rehm, Matthias Schnetzer, Sepp Zuckerstätter, Lars Nørvang Andersen, Thea Nissen, Signe Dahl, Peter Hohlfeld, Benjamin Lojak, et al.

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THE ELUSIVE RECOVERY

A slowing down recovery

The economic, financial and institutional crisis which started in 2008 looks like it is never going to end. Nearly 9 years after the meltdown of the financial system of developed countries, after a violent recession followed by the euro debt crisis in 2012, a recovery finally started in late 2014. It has been pushed by a mix of fair winds, such as low oil prices, low interest rates, a lower effective exchange rate of the euro, a less negative fiscal stance in the euro area and unconventional monetary policies. Adding to those fair winds, the Juncker commission took stock of the worrying situation in 2015 and proposed the Juncker Plan to boost (mostly private) investment in the EU.

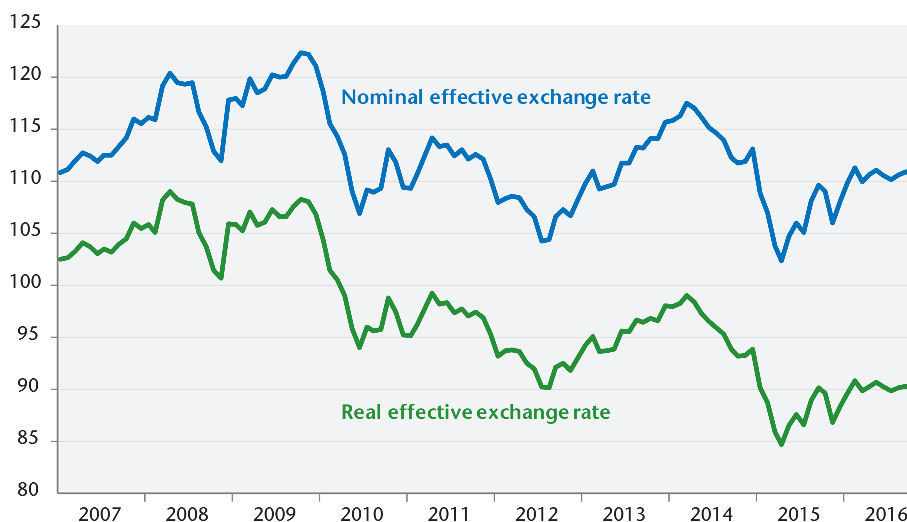
Table 1. **Breakdown of short term forecast for euro area**

	2010	2011	2012	2013	2014	2015	2016	2017	2018
GDP growth	2.0	1.6	-0.9	-0.2	1.2	1.9	1.6	1.4	1.3
Effect of … on GDP growth									
Oil	0.0	-0.3	-0.2	0.0	0.1	0.5	0.3	0.0	-0.1
Price competitiveness	0.4	0.4	0.5	0.1	-0.2	0.4	0.3	0.2	0.1
Financial conditions	-0.2	0.0	-0.6	-0.4	0.1	0.0	-0.1	0.1	0.1
Fiscal policy	-0.2	-1.2	-2.2	-1.2	-0.5	-0.3	0.0	0.0	-0.2
Emerging countries trade slowdown	0.0	0.0	0.0	0.0	-0.1	-0.2	-0.1	-0.1	-0.1
Brexit	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.0
Carry over	0.2	0.5	-1.1	-0.3	0.8	0.1	0.1	0.0	-0.1
Other	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	0.0	0.0
Sum of above effects	0.2	-0.6	-3.6	-1.8	0.1	0.5	0.4	0.1	-0.3
Growth in the absence of effects	1.9	2.2	2.7	1.5	1.1	1.5	1.3	1.3	1.6
Potential growth	0.9	0.9	0.8	0.8	0.9	0.9	0.9	0.9	0.9
Output gap*	-2.1	-1.4	-3.1	-4.1	-3.8	-2.8	-2.1	-1.5	-1.1

*Output gap is the ratio between the level of effect GDP and potential GDP and hence first difference of output gap is equal to the difference between GDP growth and potential growth.
Source: AMECO, iAGS calculation and forecast.

But despite all this, the recovery has been weak and the closing of the output gap is delayed again. We expect, as we detail in chapter 1 of this report, that economic growth is going to slow down in 2017 and in 2018 (Table 3 of chapter 1 in this report). Tailwinds are changing into headwinds (see chapter 1 in this report and Table 1). Oil prices are up again, and seem to stabilize around 55$/b. The effective exchange rate of the euro has been stable against the dollar (Figure 1). Not much more can be expected in terms of competitiveness gains through this channel. The sharp depreciation of sterling after the Brexit referendum is indeed reversing the trend and will lead to a slightly increasing real exchange rate in the next quarters. More importantly the slowdown of international trade and the slowing growth of emerging countries (as compared to before the crisis) reduce the external demand growth (Table 1) of the European Union and hence another positive factor is waning.

Figure 1. **Euro effective exchange rate, real and nominal**



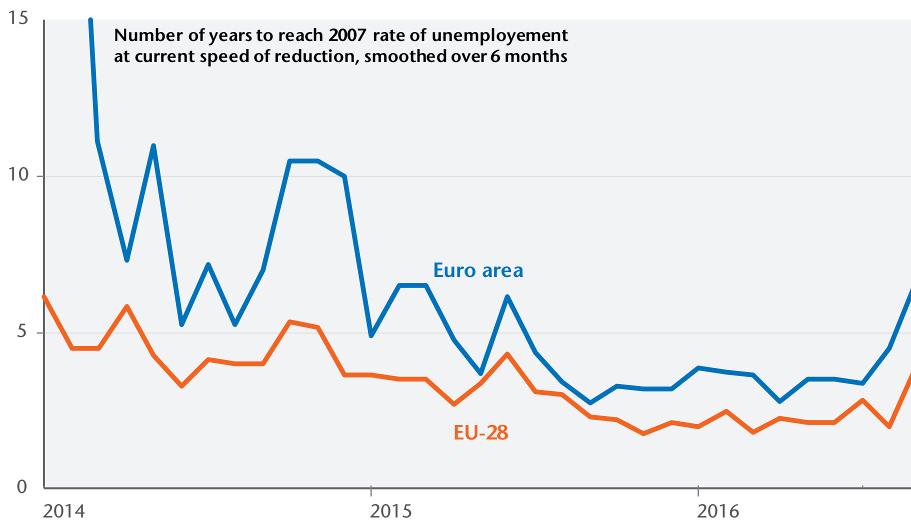
Source: ECB.

This slowing and elusive recovery comes with consequences. Unemployment has reached a high level, peaking in the second quarter of 2013 at more than 12% for the euro area and 11% for the UE28. As we document in chapter 2 of this report, high unemployment is one face of many aspects of a profound social crisis. After the 2013 peak, unemployment started to decrease. Figure 2 is showing the number of years needed, given the current pace of reduction in unemployment, to go back to the rate prevailing in 2007. The recent slowdown

is pushing this target back by 7 years. This illustrates why the recovery is elusive and how far we are from going back to the unemployment rates prevailing before the crisis. Combined with a forecasted further slowdown of the recovery, it suggests that it will require a long time to end the crisis which began in 2008.

Moreover, as we show in chapter 2, the slow clearing of the labour market is done partly through a wage adjustment, as the structural reform doctrine is advocating, and inequalities are raising at the bottom of the income distribution. That channel is strong in some countries, like Spain, where the share of wages in total value added has been sharply diminishing. Unemployment is weighting down on wages, whereas it is contributing to reduce internal disequilibrium of current accounts. However, it does so mainly by shrinking the demand for imports of euro area countries (see chapter 4 of this report). That is fueling "lowflation" and could end in deflation, locking the euro area in the wage deflation and unemployment trap.

Figure 2. **Pace of unemployment reduction**



Source: Eurostat, monthly unemployement data, iAGS calculation.

2 years ahead forecasts are not enchanting but prospects for future growth are worrying. Potential growth is slowing down, partly due to the 2008 crisis, as historical analysis suggests that the financial and banking crisis tend to have a lasting impact on economies.[1] Added to that, prospects for future growth in

1. See for instance analysis by Jordà *et al.* (2011) and Reinhart and Rogoff (2008).

developed countries are further reduced by population stagnation. Ageing population and reduction in fertility rates in developed countries, as well as the end of increases in participation rates, imply a significant slowing of the working age population and even a decreasing one in some countries (the core projection is that the labor force will be stable over the next few years for the euro area according to the 2015 Ageing Report). But productivity is also a concern. Multifactor productivity or total factor productivity (a comprehensive measure of productivity, table 2) is growing less than before, and less than in the US. That could be due to a mismeasurement of capital stock or of utilization rates of factors, especially in the crisis (explaining why numbers are so low when they include the most acute phases of the crisis). That could also be a consequence of capital misallocation, especially in the wake of the quasi bubble before the crisis. But it could also be a long trend in productivity, fueling the Gordon hypothesis of a coming secular stagnation and reviving the old analysis of the end of the dynamic of capitalism.

Table 2. **Total factor productivity growth**

Annual average rate of growth in %/year

	1987-1997	1997-2007	2007-2016	2012-2016
USA	0.9	1.2	0.6	0.5
GBR	0.8	0.8	-0.2	0.4
EA-11	0.9	0.5	-0.1	0.3
DEU	0.8	0.8	0.2	0.5
FRA	1.0	0.8	0.1	0.4
ITA	1.1	-0.1	-0.7	0.1
ESP	0.2	-0.7	-0.3	0.1
NLD	0.3	0.7	-0.3	0.5
BEL	0.8	0.9	-0.1	0.1
AUT	0.8	1.1	-0.4	-0.2
IRL	3.0	1.5	0.6	1.6
FIN	1.3	2.0	-0.6	0.1
PRT	1.0	-1.0	-0.6	0.4
GRC	1.7	1.8	-2.5	-0.6

Source: OECD Economic Outlook 99, iAGS calculations. TFP is defined as rate of growth of GDP minus growth of production factors weighted with their share in GDP. Labor (not corrected for human capital) and non residential capital are taken into account.

By itself, a slowing down in GDP growth should not be a disaster. As we recall in chapter 2 of this report, GDP is a partial measure of wellbeing. It is an average index hiding a dynamic of inequalities. It is a monetary measure, accounting for monetary economic activity and ignoring non-market flows such as domestic work or damages to Nature. It is because of that a crude measure of social and environmental sustainability. So a full account of future prospects should disregard the GDP index and point to other kinds of indicators.

The slowing down of GDP growth, however, means that future monetary flows are not going to ease the weight of debts (public and private) as was the case, for instance, after WWII. The secular stagnation hypothesis, in its Gordon fundamental form, would ask for further adjustment of public finance.

A policy mix unable to avoid the trap of secular stagnation

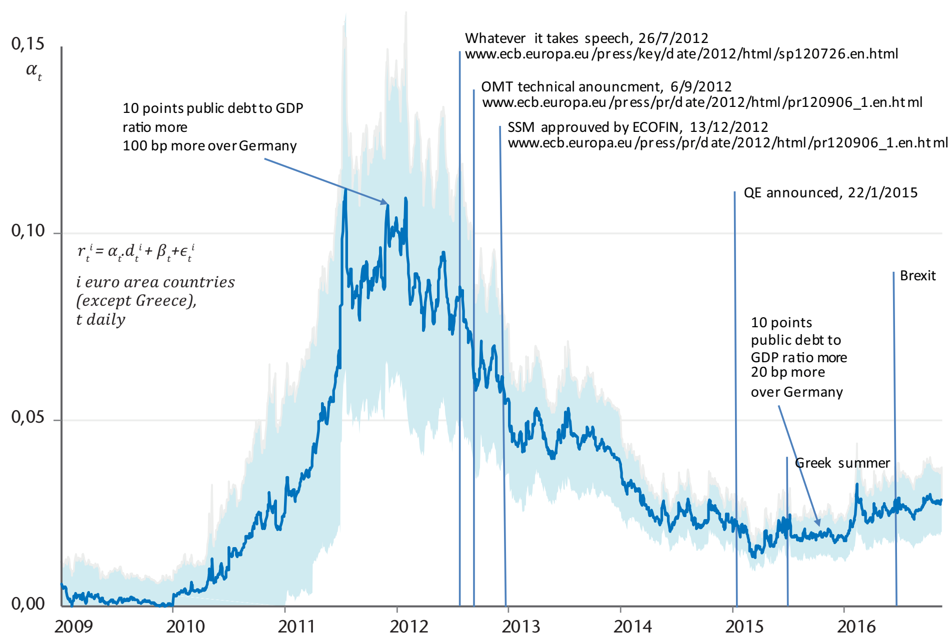
The euro debt crisis of 2011-2012 was temporarily solved with a decisive intervention by the European Central Bank on July 2012 (the famous "whatever it takes" from Mario Draghi). This intervention marked a turning point in the spirit of the Union, allowing for a limited solidarity between member States. The ECB has been the corner stone of this new doctrine (figure 3), first with the introduction of OMT and more recently with the launch of *Quantitative Easing*.[2]

Nevertheless, the explicit price for this change in doctrine has been a forced frontloading of fiscal consolidation. Thus, fiscal policy had a strongly negative impact from 2011 to 2013 (see table 1) and has contributed to the deepening of the crisis.

By giving its full expression to what was only a potential risk of a "sudden stop", frontloading was a mistake. Panic-driven austerity in the face of sanctions from financial markets does not restore any sort of confidence and can only deepen and diffuse a recession. As we argued in previous iAGS, reducing fiscal deficit at a time of large fiscal multipliers is inefficient. A better approach would have been to backload fiscal consolidation, given that intertemporal consistency of governments was guaranteed. That analysis is now, belatedly, nearly a

2. By relying partly on national central banks to buy assets, especially national sovereign bonds, the solidarity between member States is limited to 20% of total amount outstanding. This shows, if necessary, that resolute intervention of central banks is not necessarily equal to a transfer potential or actual between member States.

Figure 3. **Index of market discipline for member states**



Source: Eurostat, datastream, ECB, iAGS 2017 computations.

consensus among observers and one could argue that fiscal consolidation has been a proof that member states are indeed committed to fiscal stability (whatever it takes for them too, so to say). Based on that costly and nearly absurd demonstration, a more efficient approach to debt stabilization and reduction may be applied from now.

This situation refers to another type of secular stagnation than the Gordon sort. It is closer to the analysis of Larry Summers, building upon Hansen's work.[3] Some have formalized the idea of a multiple equilibrium economy where, through the interaction of balance sheets, investment, productivity and expectations, a fiscal stimulus could have a very strong effect on the short-term outlook of the economy, when the economy is in a severe recession or what was called a few years ago a liquidity trap (Krugman *et al.* (1998)). The IMF, in an influential analysis, concluded that fiscal multipliers could be as high as 3 in the short term in such situation, confirming the basic approach underpinning successive iAGS.

3. Whereas Hansen was also preoccupied by a Gordon type secular stagnation.

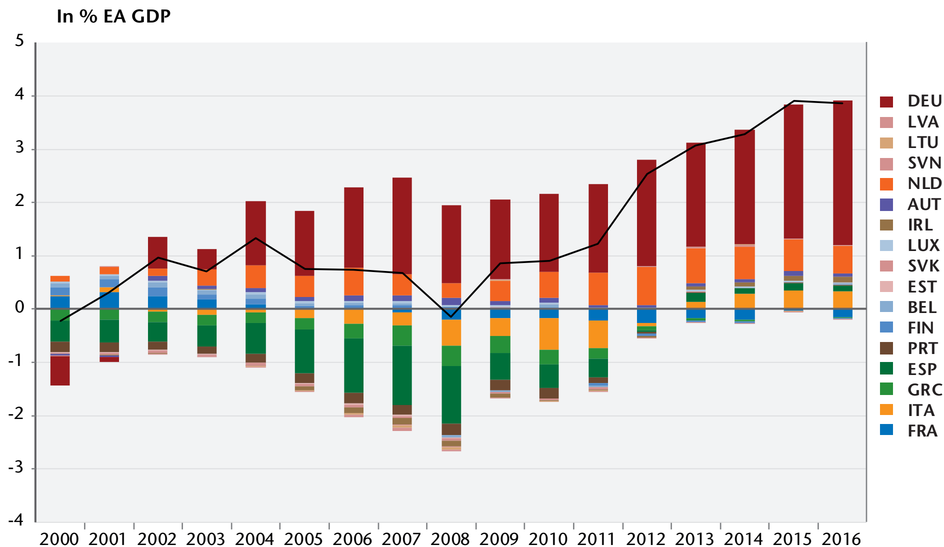
The negative fiscal stance came to an end slowly in 2015 and the Juncker plan was designed to reverse the negative impetus to the economy. The new doctrine behind the Juncker plan was that a stimulus was needed at the euro area level and that an investment stimulus would achieve simultaneously a short-term macro boost to escape the secular stagnation trap and to build up assets and achieve higher productivity levels to ensure sustainability of public debt and pension systems in the long run.

The Juncker plan has failed to deliver both. Its impact has been broadly positive, but neither the needed stimulus in the short term nor the increase in potential growth in the long term are going to happen in the current form of the plan (see chapter 3 of this report for a detailed analysis). The reason is that, at heart, the Juncker plan is a reduction in the interest rate that investors are facing by insuring their investment from some specific risks. The Juncker plan is to be understood as an extra insurance on investment projects, but not as a tool to reverse the logic of self-fulling secular stagnation. The insurance is a rather small reduction in the cost of capital and that reduction is not different in nature from the already present effect of conventional and non-conventional monetary policy. We document in chapter 3 of this report the combined effect of non-conventional monetary policy and the Juncker plan has been so far positive but insufficient to provide the stimulus needed. We also caution against excessive reliance on capital markets union to support a return to balanced and stable growth. Our analysis suggests that positive impacts should not be overstated, while a modelling exercise draws attention to potential stability risks of securitizing loans, one of the pillars of CMU.

Euro area underperforming and the risk of the appreciation of the euro

Two symptoms of the insufficient overall momentum in the euro area are its weaker performance than comparable economies and the persistence of a large current account surplus (see Figure 4, 3.8% of EA GDP, 394 bn€ in 2015, much more than China's surplus). This surplus indicates that, globally, the euro area is saving and accumulating assets denominated in foreign currency.[4] It also means, that when monetary policy normalizes (and pressure to do so is building up very quickly), if the current account surplus is not reduced, then the appreciation of the euro will be unavoidable. That also means that assets accumulated with a lower euro will lose value.

Figure 4. **Euro area current account surplus**



Source: OECD Economic Outlook 99, iAGS calculations.

As argued in the iAGS 2016 and as developed in chapter 4 of this report, the appreciation of the euro (in effective terms) will amplify the centrifugal forces at play inside the euro area. Brexit has created a precedent, giving some appeal to the idea of a radical referendum in other countries, too. Conflicting interest over monetary policy and re-debalancing of the current account, could well open one or many other existential crises of the euro. What was experienced with pain and awe during the summer of 2015 and the Grexit scenario could well reproduce itself and finally the euro could break up. Joseph Stiglitz (2016) is even adding some concerns by arguing that the uncertain adventure of splitting the euro area into smaller more homogeneous parts could be a better solution than to keep it together the way it is. Let's not be tempted by the unknown of the exit, but rather, let's heed Stiglitz' warning that failing to change the Union is no longer an option.

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4. It is presently difficult to calculate what the exposure of the euro area to other currencies is. Given the extent of the EA surplus, however, it is difficult to imagine that assets accumulated could be in euro. That is marking a sharp change since 2007 when the euro area was nearly at the current account equilibrium. Surplus countries were then accumulating assets inside the euro area (on a consolidated basis), insuring themselves from exchange rate risks. The counterpart may have been a larger risk of default, only partially materialized with the Greek partial default (PSI in 2011-12) and the reduction in the net present value of the debt of countries under the emergency financing of ESM/EFSF.

Figure 5 displays a panel of indicators summarizing the situation of the euro area and comparable economies, hit as much, if not more, by the 2008 financial and banking crisis. Different choices have been made. On the one hand, the euro area managed to stabilize its public debt more and has accumulated external surpluses, saving more than investing. On the other hand, the United-States and the United-Kingdom have been more pragmatic about public deficits and debt, have thus attracted saving from surplus countries and recovered quicker and sooner from the 2008 crisis. Of course, neither the US nor the UK had to suffer from the euro debt crisis because their central banks, unconstrained by the institutional complexities of the euro area, took up their role sooner and triggered non-conventional policies more effectively. One result is that productive public and private investment is picking up, building the grounds for future prosperity. We show in chapter 2 that, moreover, the idea that the euro area is less prone to increasing inequality, and that would render its economy less dynamic is a wrong one. Not only had the euro area less growth, but inequality has been on the rise as well. Once again, one of the drivers of inequality is growing inequality between member states, constituting another centrifugal force to the Union.[5]

The data on Figure 6 shows a diverging situation inside the euro area. Divergence between member states means that exposure to future shocks is going to be different. It also suggests that market mechanisms and calls to structural reforms are only a weak correction device. That argument is fully developed in chapter 4 of this report and one important conclusion is that to ensure convergence and current account rebalancing inside the euro area, decisive counteraction by policymakers will be needed: just letting more flexible labor market clearing mechanisms play will not deliver acceptable results. The adjustment of current account imbalances we have seen largely reflects demand effects and as such are not yet necessarily sustainable (chapter 4 of this report).

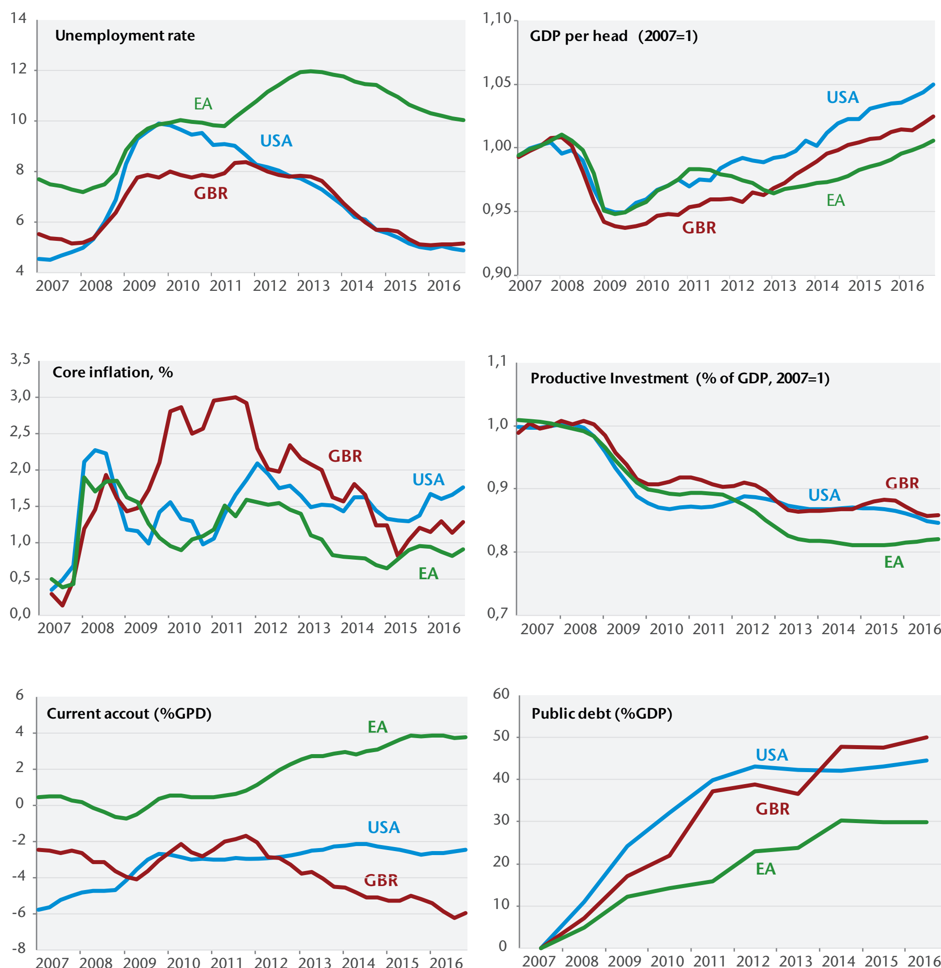
If an appreciation of the euro occurs and, correlated to if not caused by the tapering of unconventional monetary policy, centrifugal forces will be amplified even more. That should point to the urgency of solving the current crisis and escaping as quickly as possible the stagnation trap in which the euro area finds itself.

5. Prior to the crisis, as shown in chapter 2 of this report, inequalities between countries were declining.

What threatens the Union is not a Gordon type secular stagnation. May be member states are better equipped to deal with inequalities and social investment than are more individualist societies like the US or the UK. But the Union and the euro area could well die from their own poison, a self-inflicted secular stagnation and an incapacity to build an economic future.

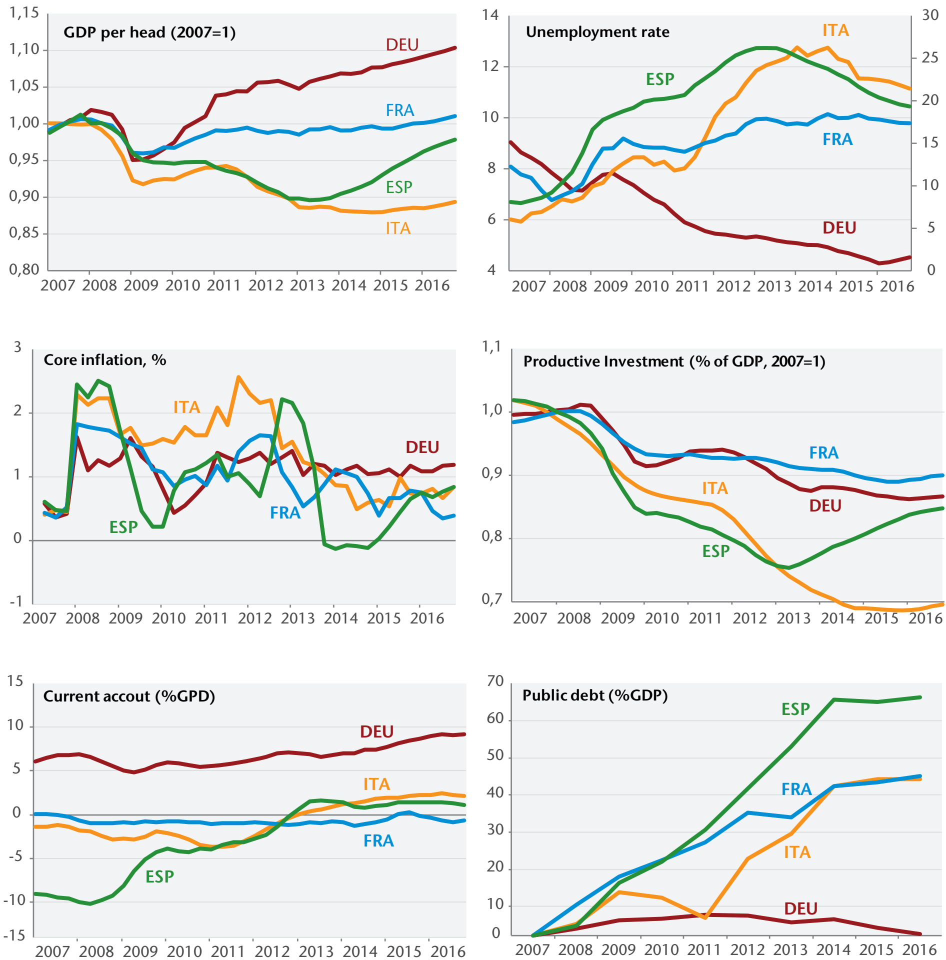
Stiglitz's dark prophecy has to be refuted.

Figure 5. **EA vs USA vs UK**



Source: OECD Economic Outlook 99, iAGS 2017 calculations.

Figure 6. **Largest euro area countries**

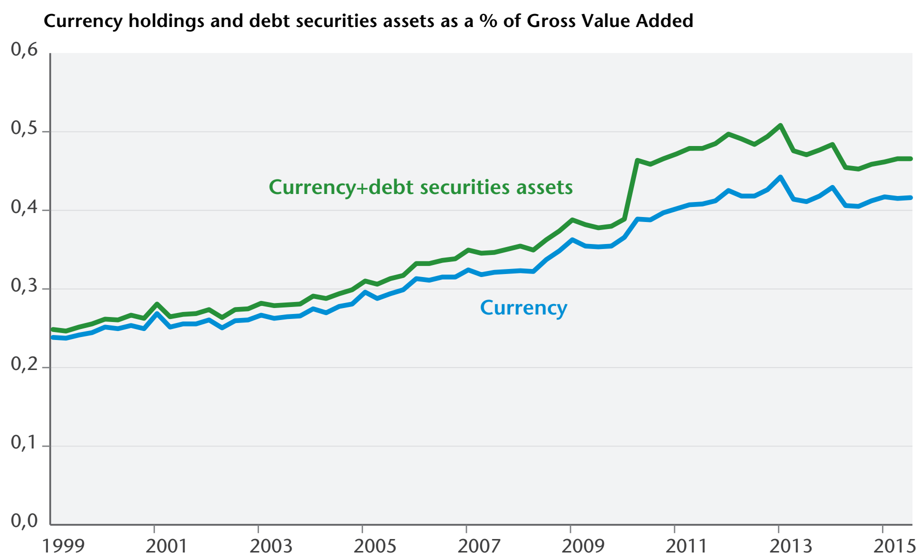


Source: OECD Economic Outlook 99, iAGS 2017 calculations.

A time of multiform uncertainty

Investment is not picking up despite abundant liquidity, low rates, and free risk insurance from Juncker plan. Firms are holding cash (nearly half a year of value added) as shown in Figure 7. Deleveraging has been realized and public debt is stabilized and still confidence is not back. The continental wide paradox of thrift is continuing.

Figure 7. **Cash held by Non Financials Firms**



Source: ECB, *Quarterly financial accounts.*

Decreasing interest rates are failing to stimulate investment because uncertainty is multidimensional and not determined by financial considerations only or even primarily. We can identify at least 5 sources of uncertainty: (1) a social crisis as documented abundantly in chapter 2; (2) a political crisis with the rise of populist and sovereign parties, closely linked to the social crisis, but also to the apparent powerlessness of the current institutional set up to provide a way out of the crisis. The migrant crisis ends up scapegoating foreigners while blaming domestic elites; (3) a crisis of faith in the European construction, the extent of which was demonstrated by Brexit, ranging from dissatisfaction with a poorly functioning transnational democracy to the painful reopened discussion of the right size of the euro area; (4) a macroeconomic question, the possibility of a so called Summer secular stagnation, where the failure of coordination between economic agents translates into deflation and sluggish potential; (5) 9 years after the beginning of the banking and financial crisis, an on-going bank problem and a nearly still born Banking Union that is not up to cleaning up the balance sheet of banks and is preventing member states from doing so themselves (see chapter 3 in this report).

Such a multiform uncertainty would require a full political package. The answer is not only economic: it has to be systemic.

Fixing it: what to do?

The political side of the solution is in reinforcing the Union. After Brexit, reinforcement of the Union should also be a clear redefinition of the legitimacy of the Union (the democratic component) and of the scope of the Union (what is federal? what is not?). The report of the 5 presidents had started a debate. But today, it seems everything is on hold.

The inequality and social question remains mostly on the shoulders of national governments. But dealing with social questions comes with fiscal needs, under the scrutiny of the Union and the fiscal rules. So first, one need to redefine those rules to allow for investing in future generations through public investment including education. Second, a step forward in fair tax competition is essential for the social cohesion of each member state and of the Union. Allowing for tax justice and avoiding loopholes, aggressive tax optimization and tax evasion in of the utmost importance when it comes to inequality.

The banking system's troubles must be resolved. Either, this is the moment to finish the Banking Union or redefine it to allow member states to intervene. The appealing idea of disconnecting sovereign bond holders from sovereign bond emitters may be unrealistic, but it is not a sufficient reason to let a zombie institution (the unborn Banking Union) not resolve zombie banks.

Internal imbalances need more than market mechanisms and structural reforms. We have proposed a golden rule for wages in the iAGS 2014, and our subsequent analysis reinforces that insight. It is not straightforward to influence wage and price formation in a market economy, but there are some direct instruments (minimum wage norms, trade unions legislation, detached workers, fiscal tools) that could be coordinated among member states to promote balanced and thus more sustainable economic growth. In Chapter 4 we discuss broadening the remit of the advisory Fiscal Council at European level and of national productivity boards (which should be cast as advisory convergence councils), for example by using the newly established National Productivity Boards. Implementation of an agreed and consistent policy stance would be facilitated by substantially strengthening that the Macro Economic Dialogue (MED), introducing a MED at the level of the euro area, ensuring its interaction with the Eurogroup, while ensuring articulation with member states by establishing national MEDs. What is key is a policy mix that is appropriate in aggregate and at the level of individual member states.

The macroeconomic question should be dealt by an active demand management. Backloading is possible now that member states have shown their commitment to fiscal discipline. Now that all euro area countries have or will soon reduce their public deficit under the 3 % ceiling, it is time to create fiscal space instead of enforcing a new wave of fiscal consolidation with the aim to bring down structural public deficits to 0.5% of GDP or the public debt ratios to 60%. Shifting from short term constraint to long term horizon creates fiscal space where it is needed. A golden rule for public investment would allow the fiscal targets to be reconsidered. When public investment is efficiently managed, then, one can expect a positive impact on potential growth. As the process of incorporating the Treaty on Stability Coordination and Governance and other intergovernmental advances in response to the crisis is underway, it would be wise to use that opportunity to incorporate those forward-looking elements in the fiscal discipline rules.

Academics (Bom and Lightart (2014) for a recent survey) agree on an elasticity around .1 between public capital stock and potential growth. That means that a permanent increase in public investment by .1% per year, with a 20-year lifespan of the investment (a higher life span multiplies the effect), would increase in the long term public capital stock by 2% and long term output by .2%/year. Our simulations in chapter 4 of this report show that, when this effect is added to the plain Keynesian effect (short term multipliers) and to wise backloading (higher fiscal multiplier when unemployment is high and monetary policy is at the zero lower bound), when limiting the ex-post increase in debt to 1% (full public financing of the investment, front loaded immediately) gross public assets can increase as much as 1.6% by 2035. A smart golden rule cannot rule out a choice when net public assets are increased by such a large margin.[6]

6. This effect depends a lot on the link between public investment and output. With an elasticity of .1 between the stock of public productive capital (to be understood in a broad sense) and the level of output, one gets 1.6% GDP of assets for 1% GDP debt so .6% GDP of net assets on average for EA member states. Bom and Lightart retain a range from .08 to .17. With an elasticity of 0.05, the increase in net assets in 2035 is nearly 0 on average in the EA and with an elasticity of 0.15 the effect is about 2.6% GDP for gross public assets. The effect depends on the country, because fiscal multipliers are larger in high unemployment gap countries. Thus, the effect ranges from 4% GDP of gross public assets for Spain with a .15 capital to output elasticity to a lowest for Germany (lower fiscal multiplier) 1.2% GDP of gross public assets with a capital to output elasticity of 0.1. This shows the importance of management and allocation of public investment as well as the consequences of back/frontloading.

The last point to add to this full package is the environmental question. We need an investment push to get out of the crisis and we need to invest in the future without wasting money on inefficient public investment. As we argued in the iAGS 2015, setting up a (or many) carbon price(s) would be one way to open a large set of high yield investment projects. Private returns would be so high that a boost in private investment would follow without the need for one public euro. With an adequate regulatory framework, market forces could ensure the correct allocation of money and answer to the needs of climate mitigation. The only drawback of a carbon price shock is that it will create many losers, from exposed households to owners of "brown" capital. Border tax adjustment could address the competitiveness question. Generous compensation scheme (including the receipts from the carbon prices, taxes, ETS) would deliver a short-term boost, complement the stimulus and provide a tool to ensure acceptance of climate mitigation.