economics

Q-Review

Business cycle analysis of Europe and the US

December 2012

- The business cycle conditions in Finland, Europe and the US are still keenly dependent on the solutions in Eurozone.
- The euro itself is a factor behind the recession in Europe and it is likely that the decisions that have made crisis worse have been made during the last two years.
- We forecast that economic growth recovers in Finland and in Eurozone during the second quarter of the next year. Growth in the US is forecasted to 'pick up steam' gradually during the next two years.
- However, these forecasts are markedly tentative due to the political uncertainty in the countries hit by the crisis.

Business cycle conditions

The world economy continues to grow in the shadow of the impending fiscal cliff and debt crisis. American consumers are the most important actor in the world economy now. The economic growth of the US has continued to be rather slow but consumers' confidence has risen to the highest value for four years. The purchaser's manager index (PMI) in China industry rose over 50 in November for the first time in 13 months (values over 50 indicate growing production). Export in many open economies, such as of South Korea, has also increased during the fall. Thus, positive signals are present in the world economy.

The puzzle in the world economy is Eurozone. The PMI of services and industry remain distinctly below fifty, the unemployment rate is the highest since the start of euro, Eurozone is in a technical recession, i.e., its GDP has reduced during two consecutive quarters. The downward spiral in the economies of Greece, Italy and Spain is steep. In Italy, 450 000 companies have finished off during the last three years. The non-performing loans increased by 15% and loan losses increased by 21% in October.

In Spain, the prices of houses are still falling, but they do not sell well yet. The unemployment rate is more than 25% and the government budget deficit is likely to exceed 8% this year. There is also a threat of referendum on independence in Catalonia which is the economic engine of Spain.

However, the situation in Greece is the gloomiest. The IMF has predicted that the sovereign debt will reach 200% of GDP by the year 2014, the current rate of unemployment is 26%, and the youth unemployment is almost 55%. The GDP of Greece has fallen more than 20% of its 2008 top. To compare, during the depression in 1990 –1993 GDP decreased by 13% and the unemployment rate rose to 18% in Finland. In the US, GDP decreased by 30% and the unemployment rate rose to 25% during the 'Great Depression' of the 1930's.

It is likely that Italy, Spain and Portugal survive in euro after their debts have been restructured in a suitable way. With Greece, the situation is more difficult. For Greece to regain competitiveness, it needs both considerable austerity measures undertaken by Greece itself and a brisk inflation in the more competitive economies like Germany and Finland. It is unlikely that Germany and Finland are ready for that. It is also very questionable, whether such an intentional diminution of competitiveness is economically feasible. The trade imbalances within Eurozone would eventually even out, but only through decreasing purchasing power and living standard of the consumers in more productive economies.

The internal devaluation in Greece has already collapsed the living standard of its citizens. Even so, Greece has not gained the sufficient competitiveness. In the latest plan of the euro-leaders, Greece should reach the primary surplus, (budget in surplus without interest payments) during 2014, after which debtors can cut the sovereign debt of Greece. This schedule is extremely disadvantageous to Greece. If its economy proceeds in its downward spiral, Greece will experience the deepest depression in the history of Westerns economies. Greece will thus pay a high price for its euro membership.

The unpleasant fact is that Europe and the world economy would not be in recession without euro as it would have been impossible for the crisis countries to accumulate the current levels of debt and to lose their competitiveness without it. However, blaming euro alone is misleading, as the decisions worsening of the crisis, have been made within the last two years. The latest 'fixing' measure is the OMT program declared by the European Central Bank in September. In this program, the ECB commits to buy 'unlimited' amounts of the sovereign bonds of those crisis countries, which agree on tough austerity programs. After this announcement, the interests of the sovereign bonds of the crisis countries have fallen as expected, even though the upcoming election in Italy has increased the uncertainty and the interest rate again.

However, the proposed OMT program can only be a temporary solution. This is because it masks those weaknesses in the economies brought into light by the market forces through the high interest rates of sovereign bonds. This program has also made it possible for the crisis countries to borrow from financial markets again, thus making them even more indebted. If the economic position of the crisis countries do not improve in the nearest future, the interest rates of their sovereign bonds will start to rise again, thus forcing the ECB to start buying their bonds. But, Germany strongly resists the OMT program and it is likely that the program will not be 'unlimited' but a restricted one.

According to the latest analyses, 70.5% of sovereign bonds of Greece are either guaranteed (through ERVV, ECB, IMF) or directly owned by the taxpayers (bilateral loans). Because the economy of Greece is still diminishing at considerable rate, it will not be able to repay its debt. This means that the European taxpayers will necessarily bear losses from the admitted guarantees and loans.

In the theme section (currently available only in Finnish) of the previous Q-review published in September we also made a cost-benefit analysis on the means proposed to save the euro. According to our analysis, only returning to the spirit of the Maastricht Treaty, i.e., ending the rescue packages, will lead to a functional currency union in the long run. This would probably force some countries to exit the euro, at least temporarily. The costs of such an action would also be considerable, but according to our view, it is the only politically and economically feasible way to build a stable currency union. The market is generally the best supervisor for budget discipline. The states of northern Europe are also probably not willing to be bind to the South European countries with permanent income transfers.

The fate of Japan also threatens Europe. In Japan, the entire economy, including banks and industrial enterprises, were saved by the government and the Bank of Japan after the economic collapse in the beginning of the 1990's. A large number of unprofitable companies are still maintained by the help of ultra-low interest rates and ever-growing national debt. The economic burden caused by these companies has left Japan with zero growth for two decades. Thus, Europe seems to face a choice between a slow recovery and a once-for-all drop associated with a faster recovery.

The economy of the United States seems to continue with bipolar growth. The consumers' confidence is the highest in four years, the new orders in the manufacturing industry are increasing and the employment rate is decreasing. However, the dispute on the fiscal cliff threatens the growth (fiscal cliff is a term describing the tax concessions and cuts of government expenditures by the end of this year). The term 'cliff' is applied as the tax hikes and expenditure cuts would be so drastic that they could push the economy back to recession again. However, we believe that the fiscal cliff will be avoided as neither party will benefit from driving the country in a second recession within a period of just four years, but it is going to be a narrow escape. However, the uncertainty concerning the fiscal cliff has already delayed the investment decisions of companies thus slowing down the recovery. The biggest threat in the economy of the United States is the uncontrolled break-up of Eurozone but the probability of such an incident is quite small.

The economy of Finland was driven back into recession during the fall with the rest of Eurozone. We expect that the economic situation in Finland will improve during next year, but much depends on the upcoming wage negotiations between the labor market organizations. The recovery of the world economy is still weak and it should be considered in the wage negotiations. In table 1 we present the nowcasts and the most probable growth forecasts for the real GDP of Finland, the United States and Eurozone.[1]

Table 1. Forecasts for the growth rate of real GDP in the US, Eurozone and Finland. Source: OECD, Bureau of Statistics and GnS Economics.

Quarter	USA	Eurozone	Finland
2012:1	0.49	-0.03	0.58
2012:2	0.31	-0.17	-1.14
2012:3	0.65	-0.05	-0.13
2012:4 nowcast	0.44	-0.22	-0.21
2012	1.9	-0.5	-0.9
2013	2.1	0.5	-0.5
2014	2.9	1.9	2.3

[1] For more information about nowcasting, see the process description at the end of the report.

Scenario forecasts

In this Section, we provide three scenarios (the optimistic, the pessimistic, and the consensus scenario) along with their likelihoods. As mentioned in the previous section, the growth of the world economy keenly depends on the political decisions made in the EU. The latest decision to establish a common supervisor for the biggest European banks is a step in the right direction.

The future of Eurozone looks far from rosy. The means to escape from the crisis without severe economic setbacks are almost nonexistent. The introduction of the Eurobonds seems unlikely and the ability of nearly all the Euro countries to take more debt is restricted. In the short run, ECB is the only institution that can stabilize the economy of Eurozone through its money printing ability. ECB can, for example, buy the sovereign debt of all Eurozone countries. This would lower the interest rates of all sovereign bonds and increase the amount of money in circulation in the area. However, this would not correct the loss of competitiveness in the crisis countries in the short run and it would not encourage to a responsible budget policy. It would nonetheless be possible to recover the economy rather fast if combined with quantitative easing by the ECB and loan defaults and/or restructuring in the crisis countries. However, because Germany resists both actions, we consider that the probability for the realization of this optimistic scenario is rather small, namely 15%.

The most negative scenario for the world economy would still be an uncontrollable breaking up of Eurozone. European banks are the biggest in the world and their combined assets are approximately 350% of the GDP of countries in Europe so that the break-up would lead to a global banking crisis, as many European banks are still recovering from the financial crisis of 2007-2009. Therefore, it is unlikely that the euro-leaders will let Eurozone fail completely. We thus give the probability of 10% for the realization of this pessimistic crisis scenario.

Table 2. Current and previous (in brackets) forecasts for the growth rate of the real GDP in the euro area.

Quarter	Optimistic	Consensus	Crisis
2012:4 nowcast (september)	-0.22 (0.04)	-0.22 (-0.23)	-0.22 (-1.72)
2012:1-4 (september)	**-0.5 (-0.19)**	**-0.5 (-0.7)**	**-0.5 (-3.4)**
2013:1	0.18	-0.04	-0.15
2013:2	0.35	0.09	-1.25
2013:3	0.37	0.16	-1.75
2013:4	0.50	0.28	-1.21
2013 (september)	**1.4 (1.5)**	**0.5 (0.9)**	**-4.4 (-4.4)**
2014	**2.2**	**1.9**	**-0.7**

The most likely scenario for the world economy is a *status quo* in the Eurozone. In the short run, this means a set of measures that do not fix the over-indebtedness of the crisis countries. In practice, this means that Greece and the other crisis countries will receive bailout money from the EU and the ECB will purchase their debt from the secondary markets, if necessary. The debt burden of the crisis hit countries will not be eased and Greece is kept as a part of Eurozone by any means. We give the probability of 75% for the realization of this consensus scenario. We also expect that this course of actions will be maintained at least until the parliamentary elections in Germany in September 2013.

Tables 2-4 present the forecasts for the growth rate of the real GDP in Eurozone, the US, and Finland.

In the crisis scenario, the break-up is estimated to begin in the second quarter of 2013. In the optimistic scenario, quantitative easing and debt restructuring is estimated to begin in the second quarter of 2013.

Table 3. Current and previous (in brackets) forecasts for the growth rate of the real GDP in the US.

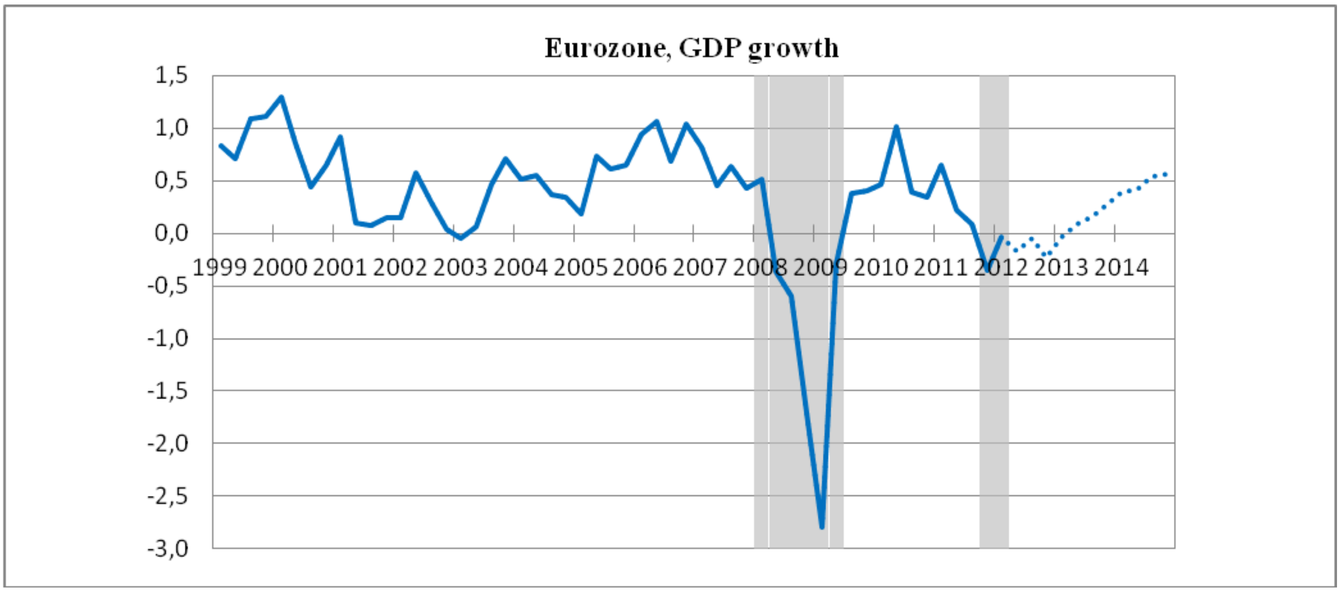
Quarter	Optimistic	Consensus	Crisis
2012:4 nowcast (september)	0.44 (0.66)	0.44 (0.66)	0.44 (0.66)
2012:1-4 (september)	**1.9 (2.4)**	**1.9 (2.4)**	**1.9 (1.9)**
2013:1	0.58	0.47	0.30
2013:2	0.57	0.46	-1.43
2013:3	0.64	0.56	-1.44
2013:4	0.67	0.60	-0.93
2013 (september)	**2.5 (3.2)**	**2.1 (2.9)**	**-3.5 (2.6)**
2014	**3.0**	**2.9**	**0.8**

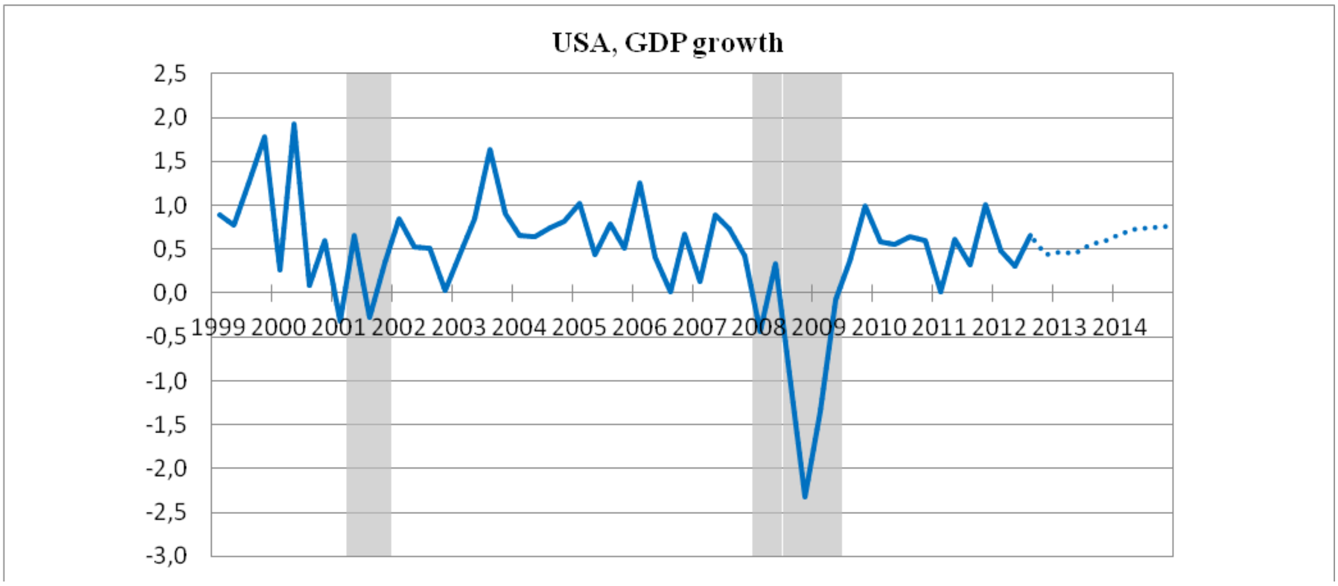
Table 4. Current and previous (in brackets) forecasts for the growth rate of the real GDP in Finland.

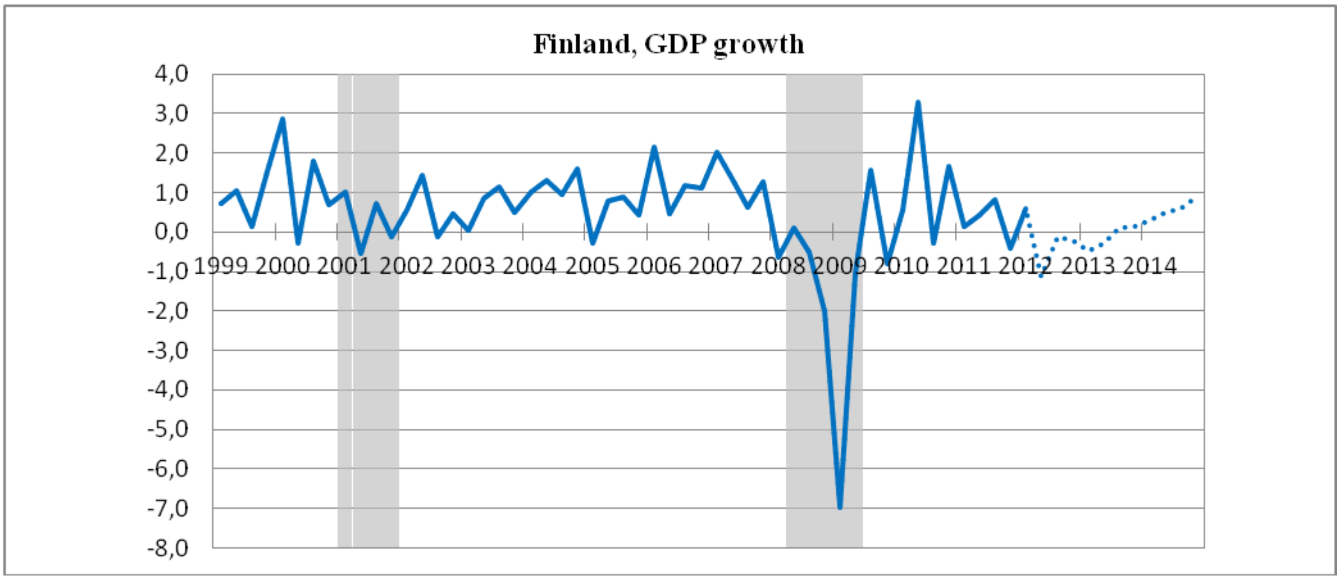
Quarter	Optimistic	Consensus	Crisis
2012:4 nowcast (september)	-0.21 (-0.10)	-0.21 (-0.19)	-0.21 (-0.44)
2012:1-4 (september)	-0.9 (-0.9)	-0.9 (-1.0)	-0.9 (-1.2)
2013:1	-0.20	-0.47	-0.66
2013:2	0.27	-0.30	-1.88
2013:3	0.47	0.11	-3.56
2013:4	0.50	0.12	-2.50
2013 (september)	**1.0 (2.0)**	**-0.5 (1.0)**	**-8.6 (-7.9)**
2014	**2.6**	**2.3**	**2.5**

Forecasts as figures

Below, the realized and forecasted economic growth rates in Eurozone, the United States and Finland are illustrated for the most likely consensus scenario. The grey areas describe the recession periods in each economy. The recession periods in Finland are based on the Makrosuhdanne blog (see http://blogs.helsinki.fi/makrosuhdanne/).


Eurozone, GDP growth
1,5
1,0
0,5
0,0
-0,5
-1,0
-1,5
-2,0
-2,5
-3,0
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014


USA, GDP growth
2,5
2,0
1,5
1,0
0,5
0,0
-0,5
-1,0
-1,5
-2,0
-2,5
-3,0
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014


Finland, GDP growth
4,0
3,0
2,0
1,0
0,0
-1,0
-2,0
-3,0
-4,0
-5,0
-6,0
-7,0
-8,0
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014

Process descriptions

The forecasts reported in this Q-review are based on the statistical modeling methods from the most recent academic research on predicting business cycle fluctuations. Nowcasts refer to the forecasts of the growth rates of the real Gross Domestic Product (GDP) for the current quarter. Nowcasts are needed because the standard measures for the GDP are published after a considerable lag and are typically subject to subsequent revisions, indicating that the coincident state of the economy is always uncertain. Our nowcasts for the current quarter are based on statistical models where all relevant information available at the time of nowcasting is utilized.

The GDP forecasts for longer horizons (over the current quarter) are based on the dynamic forecasting models where forecasts are constructed iteratively. This means, for example, that the three-quarter forecast is essentially based on the two-quarter forecasts and so on. Forecasts are constructed for all three economic areas (Eurozone, Finland and the US) indicating that they depend on each other. Finally, note that the forecast scenarios considered in this Q-review are based on the expert view of GnS economics.

The next Q-review will be published in March 2013.

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