

## Is Europe recovering?

### Special issue on the economy of Eurozone

- The economy of Eurozone is forecasted to grow by 1.1 percent this year.
- Recovery of Eurozone is already on its way but the dire state of the European banking sector threatens the recovery.
- The economy of Greece needs a debt restructuring desperately.
- For Eurozone, *Grexit* could be the beginning of the end.

Some positive signals have emerged from Eurozone during the spring but a closer exploration reveals some alarming details. On the other hand, the economy of Eurozone is threatened by a decline in the industrial production associated with high unemployment in the crisis countries, and by the insolvency of the European banking sector on the other. Even so, the recovery has clearly started but, at the moment, there is no reason to relax.

The somewhat hyped recovery of Eurozone has actually been long in the making. Economies start to recover when the economy has found its new “equilibrium” point after an economic shock (e.g., banking crisis, steep falls in exports, massive government failures). Thus, the recovery starts when the effects of a shock have been absorbed by different institutions of the society (production, wage setting, public expenditures). In the crisis countries of Eurozone, this implies that recovery starts when the salaries and public expenditures have reached their competitive levels. That is, the levels after which the production of a country is competitive within Eurozone. Figure 1 in the Appendix presents the volume of the exports in the crisis countries and Germany. It shows that exports have grown in basically every crisis country since 2010. In this sense, the handling of the European debt crisis through internal devaluations (Figure 2) has been successful, indeed. However, internal devaluations come with costs. Figure 3 presents the development the household real disposable income in the crisis countries showing a fall of

some 17 percent in Greece, 11 percent in Portugal and six percent in Spain since 2010. At the same time, unemployment remained extremely high (Figure 4).

High levels of unemployment are due to the fall of the industrial production. Figure 5 shows that the financial crisis of 2007-2008 and the recession that followed were the turning points in the industrial development in the crisis countries. Financial shock hit the industrial production in the crisis countries and there has been no real recovery so far. Financial crisis is a classic example from an ‘asymmetric shock’ in a currency union. This ‘shock’ actually reflected the difference in the Total Factor Productivity (TFP) between countries. Figure 6 presents the averages of TFP’s between 1999-2007 and 2010-2014 showing that productivity declined in the periphery already before the crisis and has continued to decline in Greece, Spain and Portugal afterwards. So, the financial crisis of 2007-2008 was just a catalyst for the effects of TFP differences between the periphery and rest of Eurozone that had been growing since the start of the common currency. It is also notable that Finland has joined the countries with declining TFP after the crisis.

High unemployment and low real disposable income threaten Eurozone in two ways. People in the crisis countries may become fed up with their poor economic position and vote for anti-euro parties. Till now this has not happened (Syriza is not an anti-euro party), but if unemployment remains

high, this is only a matter of time. Second threat arises in the banking sector. Figure 8 shows 22 countries that had the worst share of *non-performing loans* to total gross loans. Of all the countries from which data from 2014 was available, banks in Cyprus and Greece had the worst (the largest) share of non-performing loans. In both countries, some 35 percent of loans were non-performing. In total, 10 out of 22 countries in the list were European. This paints a grave picture of the banking sector in Eurozone. Usually a share of 10 percent of non-performing loans is big enough to cause problems. It thus seems that the European banking sector is kept 'afloat' mostly by the cheap money provided by the European Central Bank (ECB). It is also questionable how the already stressed banking sector is able to support the economic recovery.

The International Monetary Fund (IMF) has been successfully helping crisis countries for 60 years. In addition to the austerity measures, IMF programs have generally included some restructuring of sovereign debt and removal of currency rate pegs or fixed exchange rates. In 2010, this changed. It seems that IMF was then forced to help the survival of euro and the European banking sector with means that were against its policy and the recommendations of its own research unit. Emergency loans provided for Greece and the other crisis countries were actually bailout loans to German and French banks. They effectively transferred the risks related to the sovereign bonds of the crisis countries from banks to European tax payers and the IMF. Capitalizing banks would directly have been more effective, but it would have run the risk of breaking up Eurozone.

What about the situation in Greece? The postponing of the payment to the IMF is a trick to buy more time and many countries have used this possibility throughout the history. It is exceptional that Greece is the first western country to delay its payments. The massive sovereign debt of Greece

is feeding uncertainty which diminished private investments (Figure 7). Thus, the government of Greece is pursuing a correct policy, namely the restructuring of its sovereign debt. Without debt restructuring, the recovery in Greece cannot fully begin.

It seems that there are three factors forestalling restructuring:

- 1) Debt restructuring in Greece could raise similar aspirations in the other crisis countries
- 2) The political costs of restructuring would be large due to heavy losses to European tax payers
- 3) Restructuring would confirm that the crisis in Greece was mishandled from the beginning.

Default of Greece would be problematic as it would almost surely lead to the exit of Greece from Eurozone. However, Greece plays with a 'strong hand' in negotiations concerning the possible exit.

Probably the biggest misunderstanding about 'Grexit' is the effect it would have on Eurozone. Currently, Eurozone is a currency union. If one or more countries left, Eurozone would become a fixed exchange rate regime. This might seem like a small change, but it would have permanent repercussions. After Grexit, the possibility of the exit of another country would raise in the future. This would increase uncertainty which would lead to increased stress and volatility in financial markets. The likelihood of the bank and capital runs would also increase. Grexit would also lead to reconsiderations on the role of euro in the foreign exchange markets (euro is the second most traded currency in the world). It thus practically impossible to foresee all the effects that the exit of Greece would bring in its wake. For Eurozone, it could be the beginning of the end. At least, Eurozone would never be the same.

Greece also has some advantages considering the exit. The people and businesses of Greece have transferred massive amounts of capital and assets abroad. A majority of this will be likely to return to Greece after a Grexit, because of the big devaluation of the new currency. Because of this, Greece would become an extremely profitable country to invest, which attracts foreign investors as well. Thus, it is possible that rebound of the economy of Greece would be strong after the (probably short) chaotic period that would follow the Grexit.

All-in-all, Eurozone seems to have more to lose in Grexit than Greece itself and for this reason Eurozone leaders will try to keep Greece in the euro “at any cost”. In this sense, Syriza is playing its cards right. There is no point in giving in, when your opponent is likely to have more to lose. Still, the patience of Eurozone leaders will run out at some stage after which Grexit will happen. According to our estimate, the current likelihood of Grexit is 50 % for the next 12 months.

In Table 1, we present the *nowcasts* and the growth forecasts for the real GDP of Finland, the United States and Eurozone. According to our

forecasts, real GDP of the U.S. will grow by 1.4 percent this year. Eurozone will grow around 1.2 percent and Finland only around 0.6 percent.

Table 1. *Nowcasts* (nc) and forecasts for the growth rate of real GDP in the US, Eurozone and Finland. Source: OECD, Bureau of Statistics and GnS Economics.

Quarter	Finland	Eurozone	USA
2015:1	-0.13	0.37	-0.19
2015:2 (nc)	0.11	0.39	0.43
2015:3	0.32	0.25	0.56
2015:4	0.24	0.22	0.55
2015	0.6	1.2	1.4
2016	1.1	1.1	2.2

It seems that the long awaited recovery has finally arrived at Eurozone. However, risks for the recovery remain high. In the short- to medium term the fragile state of the European banking sector possesses the biggest threat to the recovery along with the Greece crisis. In the longer run high unemployment and an asymmetric recovery would pose the biggest threats to the European economy. These have also increased the global financial risks. According to our estimate, the likelihood of a new global economic crisis is 35 % for the next 12 months.

## 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.

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 The next Q-review will be published in December 2015.  
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APPENDIX. Eurozone in figures

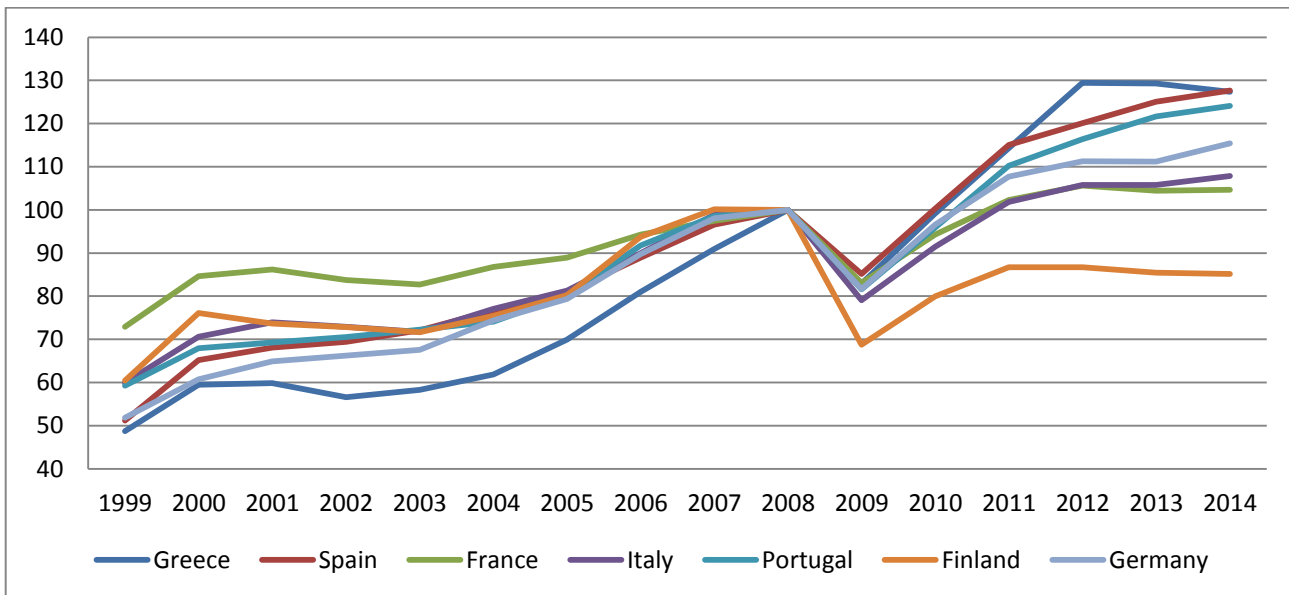


Figure 1. Volume of exports of goods and services (2008=100). Source: European Commission, AMECO database

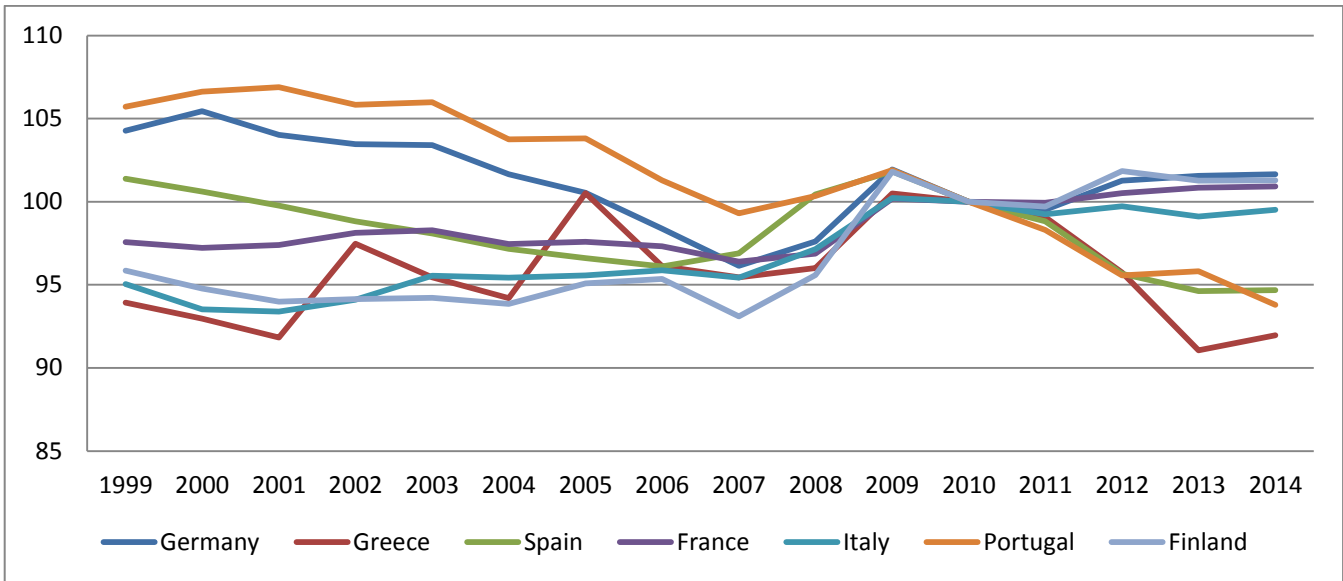


Figure 2. Real unit labor costs in selected countries of Eurozone (2010=100). Source: European Commission, AMECO database

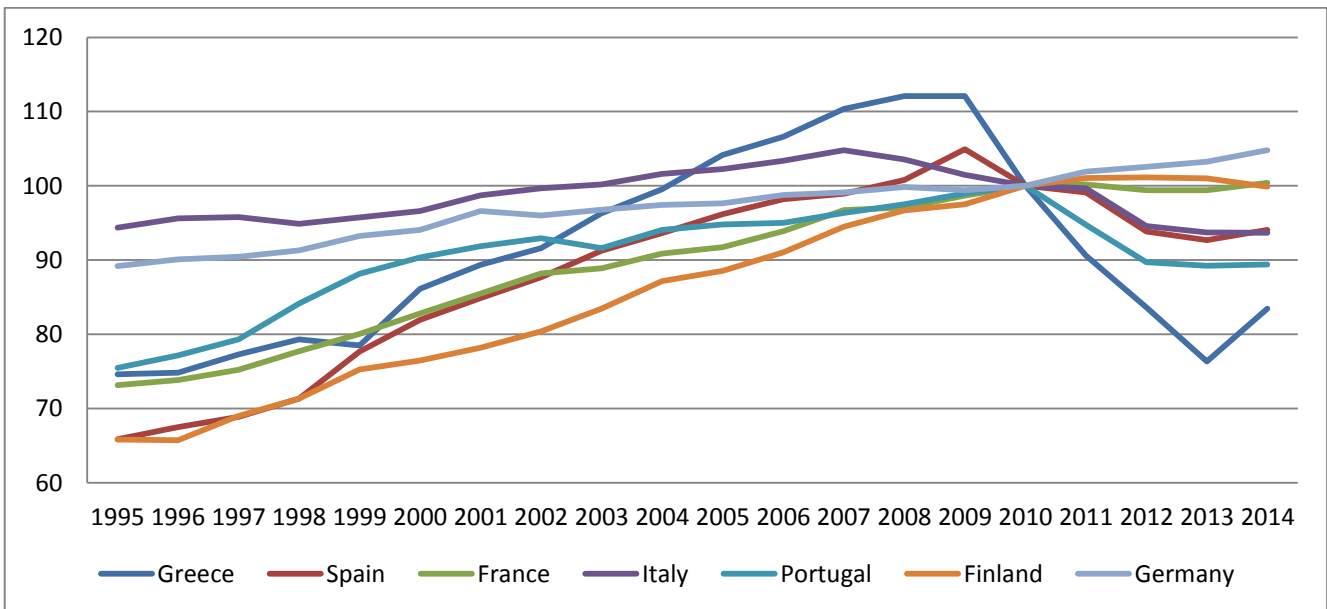


Figure 3. Real gross disposable income in selected countries of Eurozone (2010=100). Source: European Commission, AMECO database

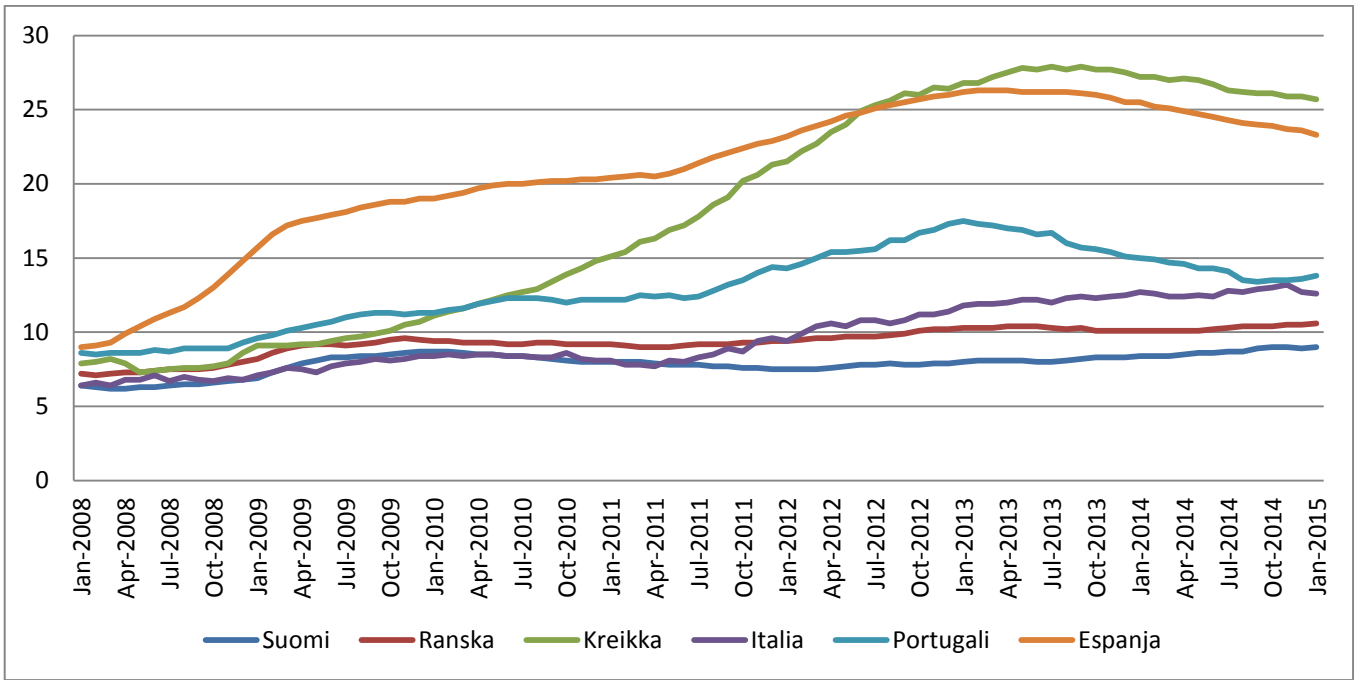


Figure 4. Real gross disposable income in selected countries of Eurozone (2010=100). Source: European Commission, AMECO database

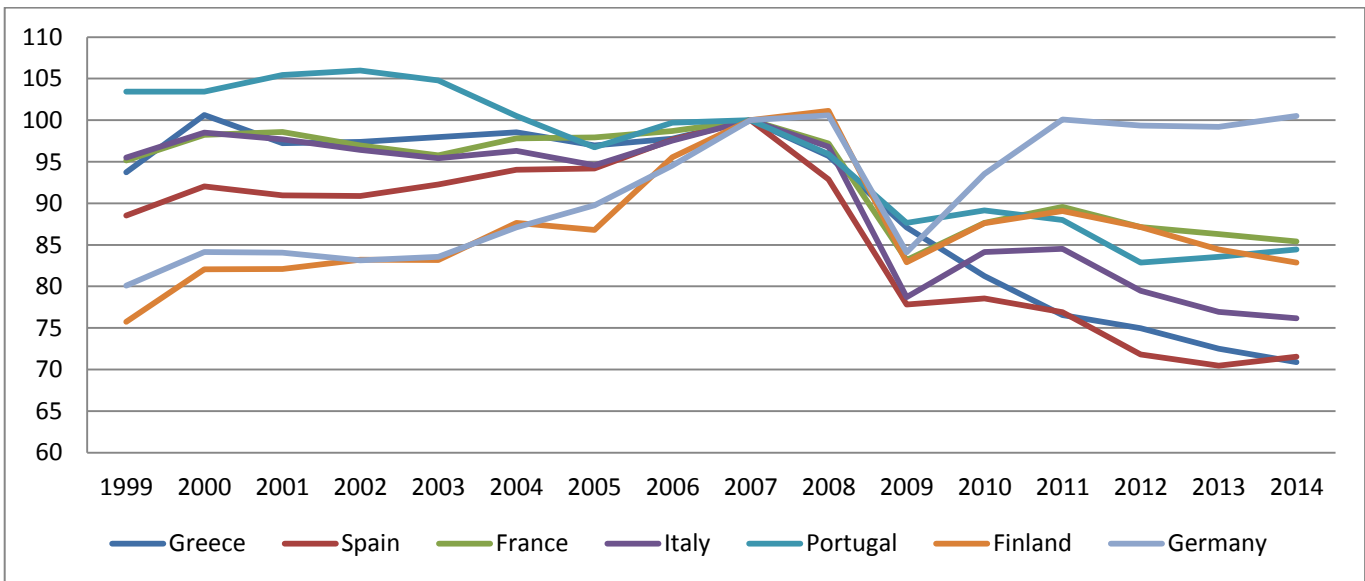


Figure 5. Unemployment rate. Source: OECD

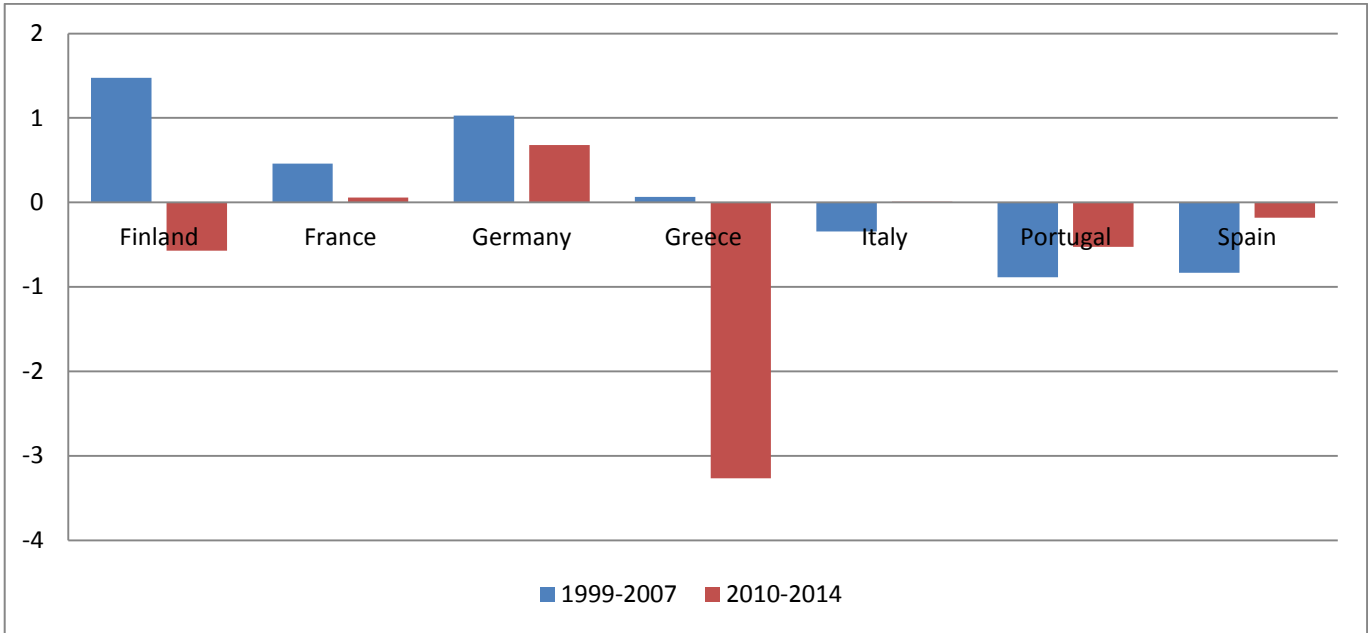


Figure 6. Total factor productivity (%) in selected countries of Eurozone. Source: Conference Board, Total economy database

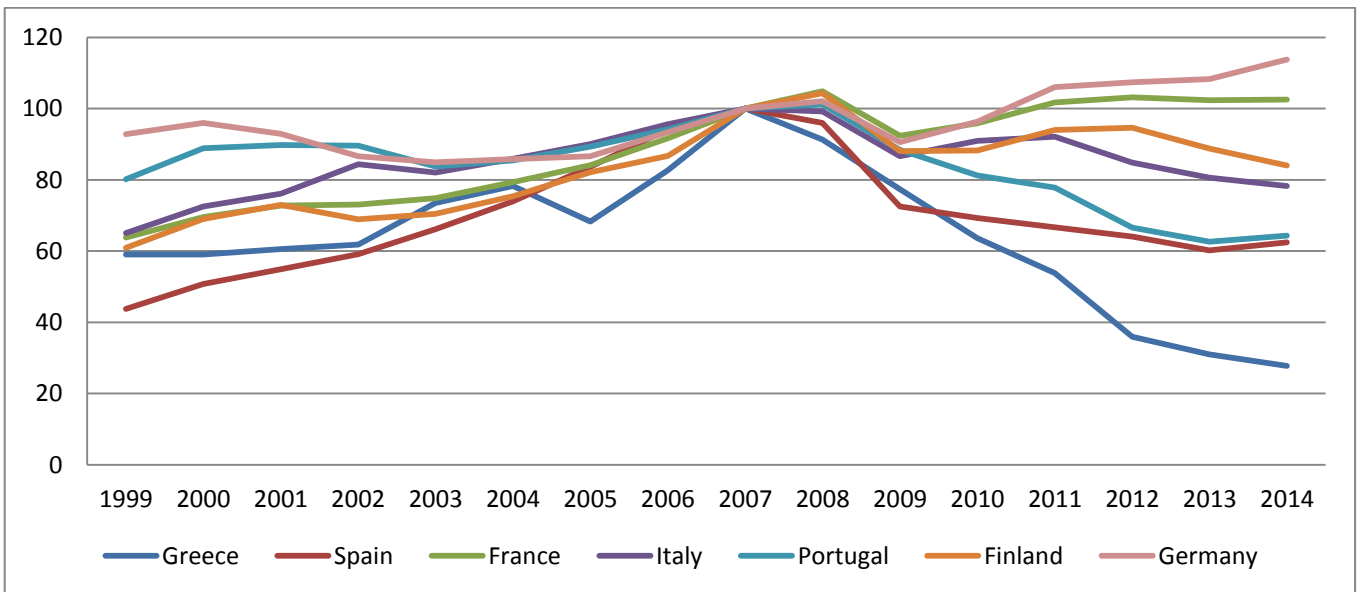


Figure 7. Gross fixed capital formation at private sector (2007=100). Source: European Commission, AMECO database

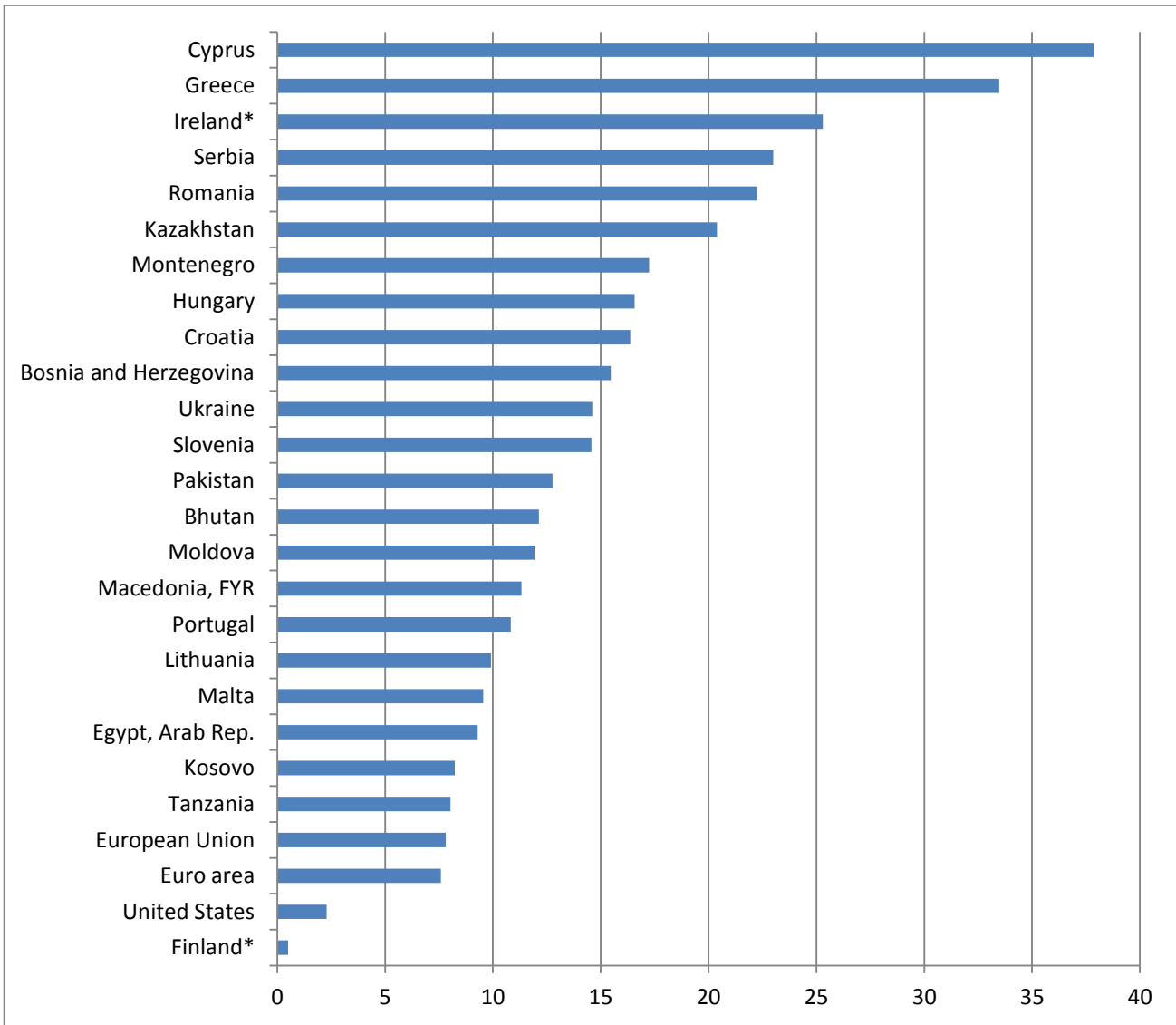


Figure 8. Bank nonperforming loans to total gross loans (%). Source: World Bank