Secular stagnation in the Eurozone

Paul De Grauwe 30 January 2015

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Nowhere in the developed world is secular stagnation more visible than in the Eurozone. This column explains this phenomenon with asymmetric external balances within the Eurozone. Southern countries had accumulated current-account deficits and became debtors when the Crisis hit, whereas the northern ones became creditors. The burden of the adjustments has been borne almost exclusively by the debtor countries creating a deflationary bias. Suggested fiscal policy prescriptions are government investment programmes, to be implemented by northern countries (and in particular, Germany).

This column is a lead commentary in the VoxEU Debate "Secular Stagnation"

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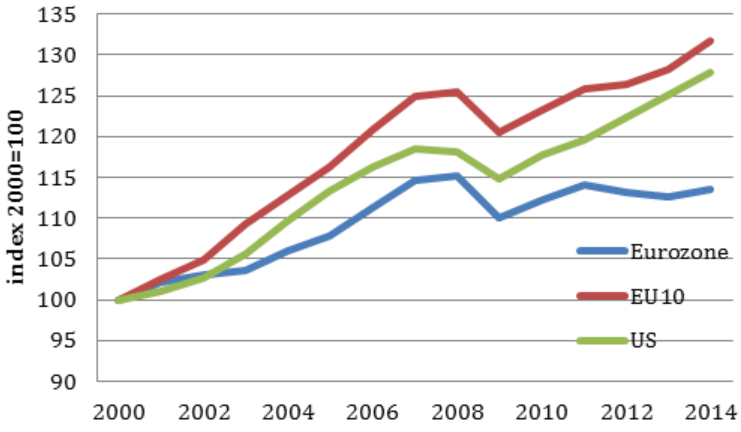
Since the Global Crisis of 2007-08 most developed countries have been unable to return to their pre-Crisis growth path. Larry Summers describes this as 'secular stagnation' (see Summers 2014 and the discussion this has led to in Teulings and Baldwin 2014).

Nowhere in the developed world is the 'secular stagnation' hypothesis more visible than in the Eurozone. Figure 1 shows this clearly by comparing the evolution of real GDP in the Eurozone, the US, and the non-euro-using EU countries (EU10 in the chart). The difference is striking.

- Prior to the Crisis, the EZ's real GDP was on a slower growth path than in the US and in EU10.
- Since the Global Crisis of 2008, the divergence has increased even further.

Real GDP in the Eurozone stagnated, and in 2014 was even lower than in 2008. In the US and EU10 one observes (after the dip of 2009) a relatively strong recovery. Admittedly, this recovery is below the potential growth path of these countries (see Summers 2014), but their recovery has been much more pronounced than that of the Eurozone. Note also that there was a recovery in the Eurozone from 2009 to 2011 and that from 2012 to 2013 the Eurozone experienced a double-dip recession.

Figure 1. Real GDP in Eurozone, EU10 and US (prices of 2010)



Source: European Commission, Ameco database

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This is the question that I want to analyse in this column. I will argue that it has much to do with the asymmetric way external imbalances within the Eurozone were corrected.

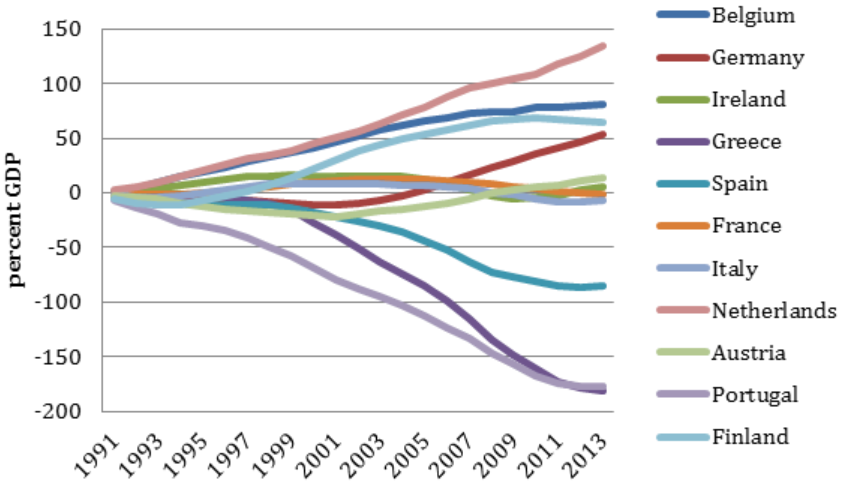
- Prior to the Crisis, the southern European countries (including Ireland) accumulated current-account deficits, while the northern Eurozone countries built up current-account surpluses.[1]

As a result, the southern countries became the debtors, and the northern countries the creditors in the system (see Figure 2).

- This forced the southern countries hit by sudden liquidity stops to beg the northern ones for financial support.

The latter reluctantly did do so but only after imposing tough austerity programmes pushing these countries into quick and deep spending cuts and intense recessions.

Figure 2. Cumulated current accounts



Source: European Commission, Ameco

Commission complicity

What is surprising is that the European Commission accepted to become the agent of the creditor nations in the Eurozone – pushing austerity as the instrument to safeguard the interest of these nations.

Another approach would have been possible and could have guided the conduct of macroeconomic policies in the Eurozone. This alternative approach is based on the view that the responsibilities for the current-account imbalances are shared between the creditor and debtor nations.

- The debtor nations took on too much debt and are responsible for that.
- The creditor nations extended too much credit and are thus equally responsible for the imbalances.

For every reckless debtor there must be a reckless creditor.

This symmetric view, however, has not prevailed in the relations between EZ creditors and debtors. The former have been viewed as having followed virtuous policies and the latter as having followed foolish ones. As a result, the debtor nations have been forced to bear the full brunt of the adjustment.

This led to an asymmetric process where most of the adjustment has been done by the debtor nations. In the absence of the option to devalue, the latter countries have been forced to reduce wages and prices relative to the creditor countries (an 'internal devaluation') without compensating wage and price increases in the creditor countries ('internal revaluations'). This has been achieved by intense austerity programmes in the south without compensating northern stimulus.

In Figure 3, we show some evidence about the nature of this asymmetry. The figure shows the evolution of the relative unit labour costs of the debtor countries (where we use the average over the 1970-2010 period as the base period).[2] Two features stand out.

- First, from 1999 until 2008/09, one observes the strong increase of these countries' relative unit labour costs.
- Second, since 2008/09 quite dramatic turnarounds of the relative unit labour costs have

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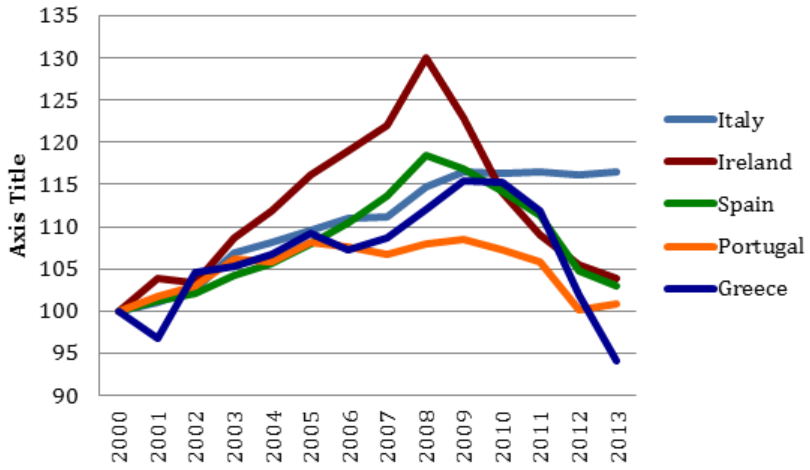
occurred (internal devaluations) in Ireland, Spain, and Greece, and to a lesser extent in Portugal and Italy.

These internal devaluations have come at a great cost in terms of lost output and employment in the debtor countries mainly because the expenditure reducing effects of these internal devaluations were more intense than the expenditure switching (competitiveness) effects.

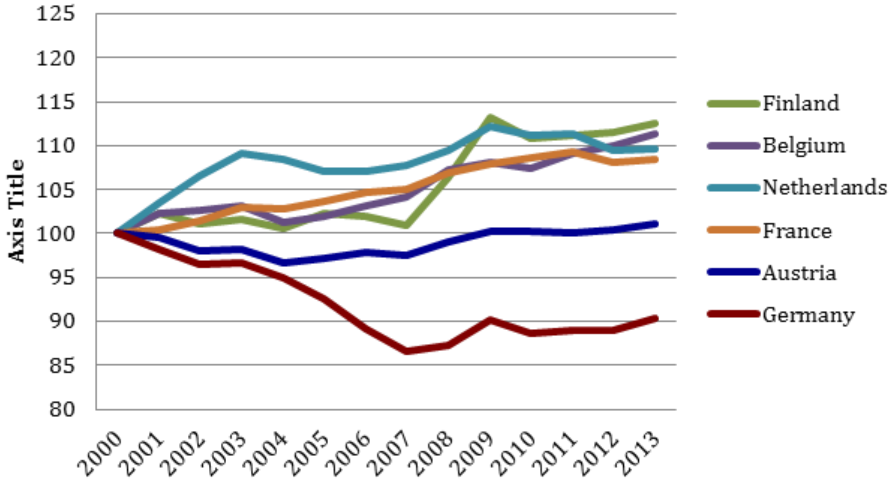
Figure 3. Relative unit labour costs Eurozone: Debtor nations



Source: European Commission, Ameco

Is there evidence that such a process of internal revaluations has been going on in the surplus countries? The answer is given in Figure 4 that presents the evolution of the relative unit labour costs in the creditor countries. One observes that since 2008/09 there is very little movement in these relative unit labour costs in these countries.

Figure 4. Relative unit labour costs Eurozone: Creditor nations



Source: European Commission, Ameco

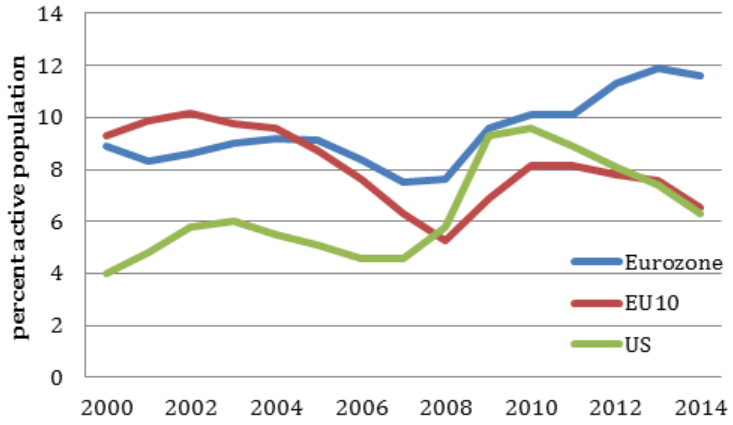
Eurozone stagnation? The answer is asymmetric adjustment

Thus, one can conclude that at the insistence of the creditor nations, the burden of the adjustments to the imbalances in the Eurozone has been borne almost exclusively by the debtor countries in the periphery. This has created a deflationary bias that explains why the Eurozone has been pulled into a double-dip recession in 2012-13, and why real GDP has stagnated since 2008, in contrast with what happened in the non-euro EU countries and in the US. It also helps to explain why the unemployment rate increased from 8% in 2008 to close to 12% in 2014, while in the EU10 and in the US the unemployment rate started to decline significantly since 2010 (see Figure 5).

The deflationary forces to which the Eurozone was subjected as a result of the asymmetric adjustment policies led to two other effects. The first one was to turn the current-account deficit that existed in 2008 into a surplus of close to 3% of GDP in 2014. This is shown in Figure 6. As the debtor nations were forced into austerity, spending declined. The latter was not offset by increased spending in the creditor nations as these nations aimed at maintaining current-account surpluses. Thus, the Eurozone adjustment process consisted in all countries of saving more, pushing the

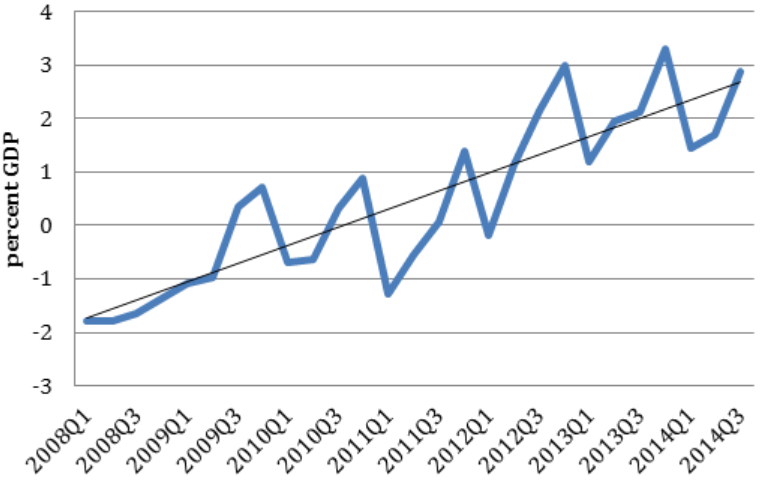
current account into a significant surplus.

Figure 5. Unemployment rate in Eurozone, EU10 and US



Source: European Commission, Ameco databank

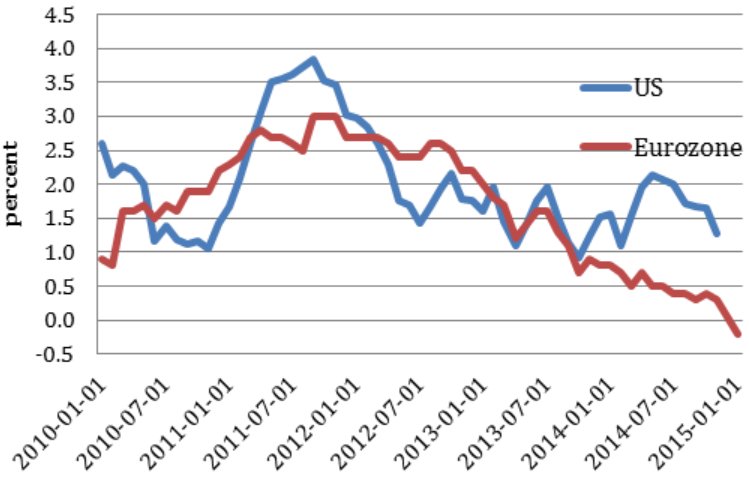
Figure 6. Current account Eurozone



Source: European Commission, Ameco databank

The second effect of the deflationary dynamics produced by an asymmetric adjustment process was a sharp decline in inflation, which at the end of 2014 became negative in the Eurozone as a whole. We show this in Figure 7 where we compare the rate of inflation in the Eurozone and in the US. It is striking to find that while the US seems to have stabilised its inflation rate around a value of 1.5%, this is not the case in the Eurozone where we observe a continuous decline of inflation since 2011, until it became negative in December 2014.

Figure 7. Inflation in US and Eurozone



Source: ECB

From the preceding analysis one can conclude that all the phenomena associated with the secular stagnation hypothesis are present in the Eurozone in a significantly more intense manner than they are in the US and the other EU countries. Increased attempts to save triggered by external imbalances (and debt accumulation) and the lack of the exchange rate instrument to rebalance the economies of the debtor nations, drove inflation into negative territory. This, in turn, prevented the real interest rate from declining further so as to equilibrate savings and investments. As a result, the Eurozone seems to be stuck into a low-growth high-unemployment equilibrium.

History repeating

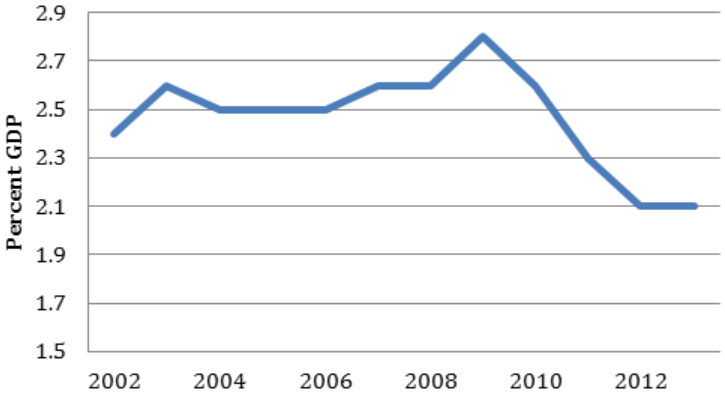
It may be interesting to make an historic parallel here. During the 1930s a number of European countries decided to stay on gold and to keep their exchange rates fixed. This forced these countries into deflationary demand policies aimed at restoring balance of payments equilibrium. As a result, they failed to recover and performed significantly worse than the countries that went off gold and devalued their currencies (see Eichengreen 1992). Something very similar happened in the Eurozone since the Great Recession.

All this leads to the question of what to do today, in 2015? As stressed by many participants in the debate concerning secular stagnation (see Teulings and Baldwin 2014), the policy mix to lift countries from the low growth and high unemployment equilibrium consists in a mix of monetary and fiscal expansion. Here I focus on the fiscal part and more specifically on government investments as one of the instruments to increase aggregate demand.

Governments of the Eurozone, in particular in the northern member countries now face historically low long-term interest rates. The German government, for example, can borrow at less than 1% at a maturity of 10 years. These historically low interest rates create a window of opportunities for these governments to start a major investment programme. Money can be borrowed almost for free while in all these countries there are great needs to invest in the energy sector, the public transportation systems, and the environment.

This is, therefore, the time to reverse the ill-advised decisions made since 2010 to reduce public investments that is illustrated in Figure 8. This can be done at a very low cost. The country that should lead this public investment programme is Germany. There are two reasons for this. First, as we have argued earlier, the asymmetric nature of the macroeconomic adjustment programmes within the Eurozone unnecessarily magnified the cost of these programmes in the debtor nations, and is responsible for the stagnation of the Eurozone since 2008. Second, public investments as a percent of GDP in Germany are among the lowest of all Eurozone countries. In 2013, public investment in Germany amounted to a bare 1.6% of GDP versus 2.3% in the rest of the Eurozone (see also Fratzscher 2014 on this).

Figure 8. General government gross fixed capital formation (%GDP)



Source: Eurostat

Such a public investment programme would do two things.

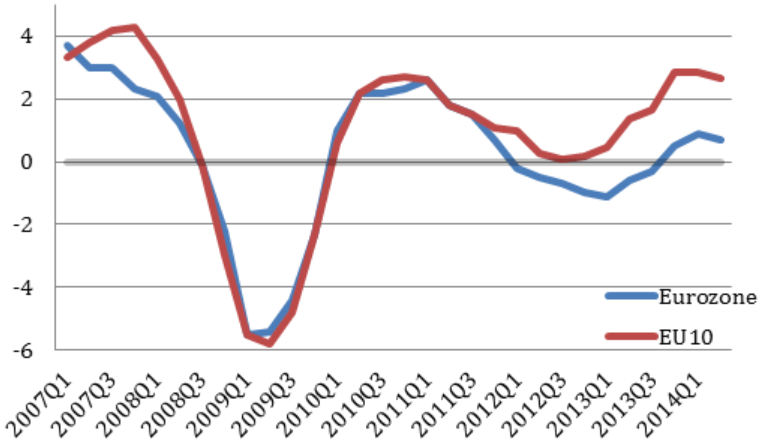
- First, it would stimulate aggregate demand in the short run and help to pull the Eurozone out of its stagnation.
- Second, in the long run it would help to lift the long-term growth potential in the Eurozone.

The prevailing view in many countries is that governments should not increase their debt levels lest they put a burden on future generations. The truth is that future generations inherit not only the liabilities but also the assets that have been created by the government. Future generations will not understand why these governments did not invest in productive assets that improve these generations' welfare, while present-day governments could do so at historically low financing costs.

There is a second factor that prevents European policymakers from using a large government investment programme in order to lift the Eurozone from its stagnation. These policymakers continue to believe that the stagnation since 2008 is a result of structural rigidities in the Eurozone. Thus, the problem of stagnations is seen as originating exclusively from the supply-side. In this view, structural reforms (together with austerity) are the answer.

While the Eurozone does have structural supply-side problems that will have to be corrected, these cannot be seen as the primary cause of the stagnation since 2008. This is made very vivid in Figure 9. I show the growth rates of GDP in the Eurozone and the EU10. It is striking to find that from 2007 until the start of the sovereign debt crisis in 2010, the growth rates in both groups of countries were very similar. In particular, both the Eurozone and the EU10 lifted their economies from the Great Recession very quickly by a combination of monetary and fiscal stimulus. From 2011 on, the Eurozone started with deep austerity programmes that led to a double-dip recession. If the cause of low growth of the Eurozone in the post-Crisis period had been structural rigidities, it is difficult to understand how despite the same structural rigidities the Eurozone recovered so quickly from the Great Recession in 2010, and why suddenly from 2011 on these structural rigidities (that are like universal constants) can be responsible for the strong divergence of the growth rates between the Eurozone and the EU10.

Figure 9. Growth GDP in Eurozone (EU18) and EU10 (percent)



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Footnotes

1 We define northern Eurozone countries to be Austria, Belgium, Finland, Germany, and the Netherlands.

2 The relative unit labour cost of a country is defined as the ratio of the unit labour costs of that country and the average unit labour costs in the rest of the Eurozone. An increase in this ratio indicates that the country in question has seen its unit labour costs increase faster than in the rest of the Eurozone, and vice versa.

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