Global Economic Outlook

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Can the ECB jumpstart the recovery?

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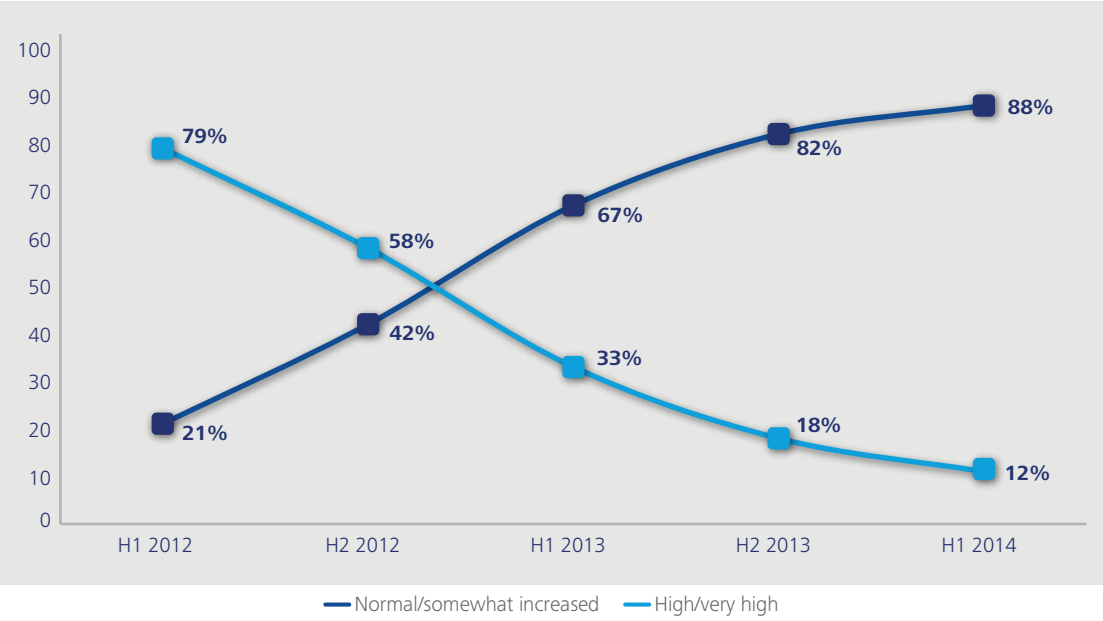
THE economic situation in the Eurozone sends mixed signals. On one hand, economic sentiment continues to be positive. On the other, the gaps in economic performance between countries are widening, and the European Central Bank's worries about growth and inflation led it to further ease monetary policy in June in somewhat unorthodox ways. Going forward, two key questions remain: Will this highly accommodative monetary policy be enough to accelerate the recovery, and what is the Eurozone's growth potential?

Positive sentiment and fragmentation

The first half of the year 2014 has reinforced three key economic developments in the Eurozone. First, the acute phase of the Euro crisis is quasi-officially over. The countries most affected by the crisis, Greece and Portugal, returned to the capital markets, and spreads on bonds of these crisis countries declined further. Second, Portugal followed the example Ireland set last year by leaving the bailout program. Both developments are evidence that the scenario of a breakup of the Eurozone has largely vanished from investors' radar. Third, in a related development, economic uncertainty continues to decline and is reaching normal levels. Figure 1 shows how German CFOs judge the level of uncertainty in the current business environment. Uncertainty has declined steadily since the height of the Euro crisis in 2012, and almost 90 percent currently see the level of uncertainty as normal or as somewhat higher than normal.

At the same time, the Eurozone as a whole continues to grow moderately, and economic sentiment is positive. The European Sentiment

Figure 1. Level of uncertainty among German CFOs (percentage)



Source: Deloitte, *CFO survey Germany*, spring 2014

Graphic: Deloitte University Press | DUPress.com

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Indicator, the main yardstick of economic expectations, has been above its long-term average since December. Even the Ukraine crisis could not stop it from rising. These factors suggest that the recovery is ongoing and solid.

Nevertheless, two trends interfere substantially with the positive picture. First, growth in the Eurozone continues to be anemic, especially considering the depth of the previous recession. The Eurozone grew by 0.2 percent in the first quarter. While data for the second quarter have not been released at the time of writing, the growth rate in the second quarter should be largely the same. Second, growth is very unevenly distributed. The gaps in economic performance among the member countries are not narrowing; quite the contrary. In the first quarter, Germany grew by 0.8 percent quarter over quarter, France stagnated, and Italy shrank by 0.1 percent. The Spanish economy grew by 0.4 percent, the first year-over-year growth in three years, driven by rising exports and domestic demand as well as a less restrictive fiscal policy.

Monetary policy stimulus

There are several factors driving these differences, of which the implementation of structural reforms is one of the most critical. Nevertheless, overall growth performance has been below expectations. Additionally, inflation figures in the last months were also lower than expected (0.5 percent in May) and considerably below the 2 percent goal of the European Central Bank (ECB). To address this situation, the ECB

introduced a series of additional accommodative monetary policy measures in June.

The ECB's main goals are to counter deflationary tendencies and to support lending to the real economy. The package includes lowering the key interest rate, offering cheap loans to banks on condition that they increase their lending to corporates, and imposing a negative interest rate on bank deposits parked at the ECB overnight. This adds up to a wide-ranging monetary stimulus program for the Eurozone. The ECB is committed to introducing additional unconventional measures if it sees the risk of a period of low inflation. However, long-term inflation expectations are still close to 2 percent, according to ECB survey research.

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The ECB's move is not without risks. Asset and real estate bubbles in Northern Europe are one of them. Nevertheless, the ECB's actions could support some ongoing positive developments in the still-fragmented credit markets. Bank credit conditions for enterprises and households have stabilized, according to the ECB's Bank Lending Survey.[1] Importantly, small- and medium-sized enterprises reported improvement in their bank loan financing conditions.

Can monetary policy be the game-changer?

Whether the ECB's actions can really jump-start the recovery depends mainly on their effects on investment activity. The program enables the banking sector to give more credit to the corporate sector at a cheaper rate, if corporates need credit for investments. With regard to the program's effects on the business cycle, the main question is whether the current low investment activity is mainly due to credit supply factors.

Survey research carried out by the ECB suggests that credit demand is more important. Small- and medium-sized companies, which traditionally have a harder time obtaining credit than large firms, cite "finding customers" as their dominant concern. Access to finance was a much less pressing issue.[2] In other words, finance is not hindering investments as much as a lack of growth opportunities. This phenomenon is similar to a trend visible in Germany. While German firms operate in a growing economy and face excellent financing conditions, they have been very cautious regarding investments and investment plans, even though uncertainty has declined.[3] In other words, an accommodative monetary policy and unorthodox measures will not be enough to jumpstart investment activity and accelerate growth. They are part of the solution, but they cannot be substitutes for structural reforms that increase the Eurozone's growth potential.

How fast can the Eurozone grow anyway?

The current growth rates in the Eurozone are modest in comparison with past growth performance. However, they are not far away from the Eurozone's trend rate of growth—that is, the average sustainable long-term growth rate. While the actual growth rate can fluctuate around the trend rate, especially if there is an output gap, the trend rate indicates the structural speed limit for growth.

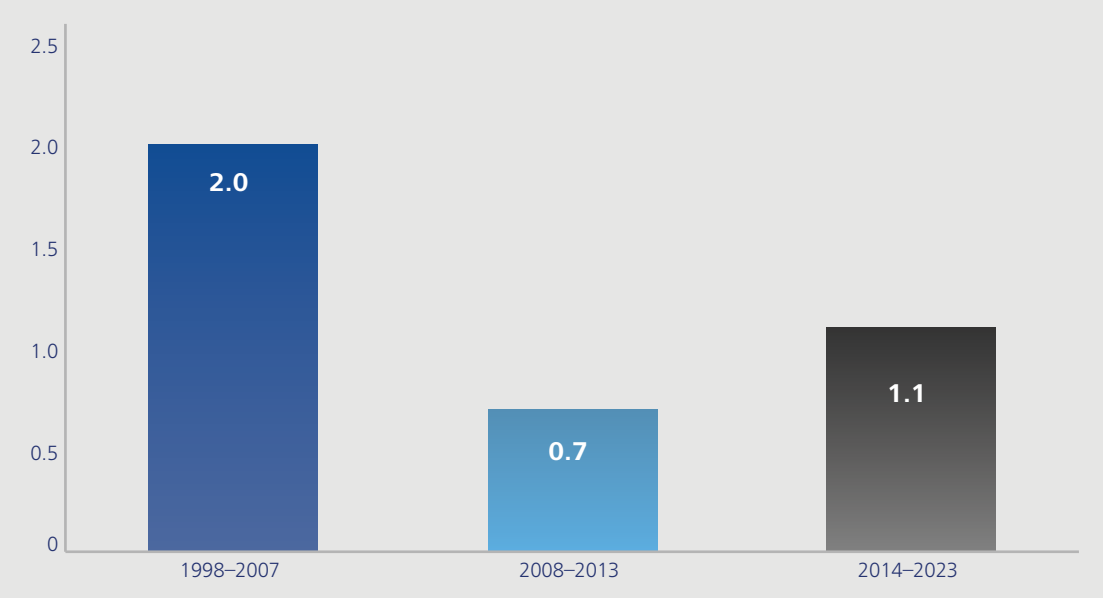
Calculations by the European Commission show that potential growth has fallen since the outbreak of the financial crisis and is projected to be much lower for the next decade than previously expected. The main reason is declining productivity performance, which started long before the financial crisis but has become fully tangible only now. Another important factor is the aging of European societies. This indicates that current growth performance not only has cyclical components that can be overcome by active monetary

and fiscal policy, but results from a mix of cyclical and long-term trends.

It needs to be stressed that future growth potential is not cast in stone. This forecast is based on a no-policy-change scenario. In this sense, the rather modest outlook is contingent on current and future economic policy.

Productivity-enhancing policies would lift the growth potential of the Eurozone. Enhancing productivity, however, depends on factors that the ECB cannot influence. The ECB's accommodative monetary policy needs support from the economic policy side to have sustainable effects on growth.

Figure 2. Potential growth in the Eurozone
(annual growth rate in percentage points, no-policy-change scenario)



Source: European Commission 2013, *Quarterly report on the euro area*, vol. 12, issue 4.

Graphic: Deloitte University Press | DUPress.com

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Endnotes

1. European Central Bank, *Bank Lending survey*, April 2014, http://www.ecb.europa.eu/stats/pdf/blssurvey_201404.pdf.
2. European Central Bank, *Monthly Bulletin*, May 2014.
3. Deloitte, *CFO survey Germany*, spring 2014.