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Eurozone

The structural decline in the Eurozone's growth potential

In the past decade, labour and capital supply in the Eurozone have weakened. The growth in potential output as a whole was subdued throughout the crisis years and Italy, Spain, Greece and Portugal even saw outright declines in potential output over recent years. This means that the euro crisis appears to have had a lasting negative effect in some member states. Their economies will now overheat at lower levels of activity than before. That will worsen their cyclically-adjusted budget balance. Greater investment in capital and R&D to improve productivity and structural reforms are needed to boost potential output.

For two years in a row, the Eurozone has grown more rapidly than the US. But this is hardly a cause for celebration, as the GDP growth rate remains on the low side compared to the pre-crisis average. How fast can the Eurozone grow without hitting capacity constraints? And how much slack is there still in the economy, allowing temporary faster GDP growth?

Looking at the European Commission's outlook the answer is pretty straightforward: although Eurozone GDP growth over the last ten years exceeded the pre-crisis growth rate of 2.3% only once (in 2017), the Commission believes that by the end of this year the negative output gap (the difference between GDP and potential GDP as a percentage of potential GDP) will be closed. This is the case even in some of the countries that experienced the deepest recessions such as Spain and Portugal. The reason for this remarkable closing of the output gap in the wake of a long period of weak growth, is the belief that the potential growth rate of the economy has structurally declined.

What is potential output?

This is an indication of the level of real output that an economy can sustain for a longer period of time given the available production factors. The developments in potential output mainly depend on the supply-side production factors: labour, capital and the productivity of those factors. The growth of the potential output level therefore depends on factors such as demographics, labour force participation, investment in capital and innovation. Structural reforms can help improve the capacity of the economy and therefore have a lasting effect on potential output. The change in this indicator, potential output growth, therefore indicates the increase in the productive capacity of the economy.

The level of potential output is relevant because it gives insight into whether an economy is overheating or still performing below potential. It is used by the European Commission to determine the cyclically-adjusted budget balance, so it is a factor in determining the limits to government spending. It might also be a beacon for monetary policy. When actual output exceeds potential, this is considered to be inflationary. Therefore it comes as no surprise that the output gap is one of the determinants in John Taylor's monetary policy rule. Estimates of potential output are often debated as it is not a tangible measure. Over time, there can be substantial deviations from initial estimates of potential output levels.

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Post-crisis developments in capital and labour are key for potential output

Measurement of potential output can differ quite a bit between institutions and can often be revised due to changes in assumptions (a 2014 ECB working paper[1] revealed large downward revisions of potential output between 2007 and 2014 for example). To get a sense of the changes since the crisis, we look at the developments in the supply-side inputs of economic output to determine whether indeed structural factors have dampened potential output over the past few years.

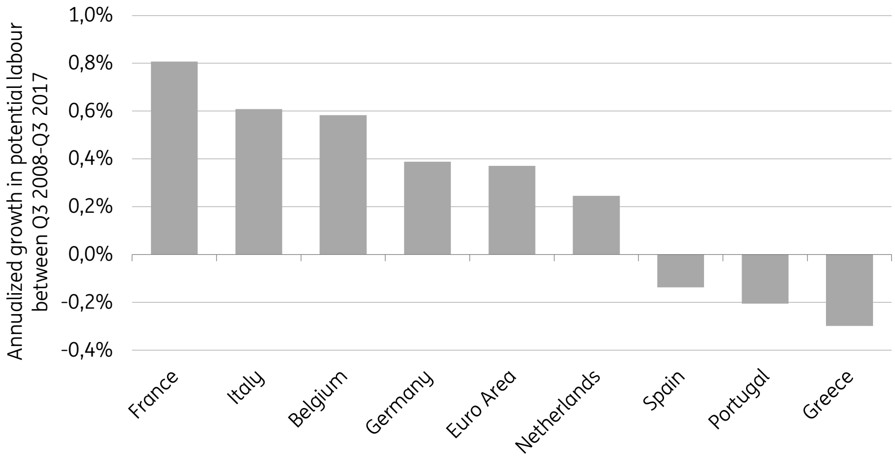
Help wanted

A good starting point is to blame demographics. With baby boomers now aged from 54 to 78, the working age population growth in the Eurozone declined over the past decades and turned negative in 2009. However, governments have not been sitting on their hands. Many countries have raised the retirement age and discouraged early retirement, which has all but counteracted the labour market effects for now.

...Labour is impacted negatively by emigration in some economies since the crisis

There are, however, a few exceptions. When we add discouraged workers to the labour supply to discard demand-side effects, we indeed find there is a mixed picture between economies. In Spain, the exodus of migrant workers during the crisis years caused the population to take such a dent that the potential labour supply is now 3.9% smaller than at the peak in 2012. In Greece, emigration has been the main culprit in a 4% decline of the potential labour supply since 2009, while countries such as Belgium, France and Italy have seen quite strong increases in labour supply since the crisis.

Fig 1 The potential labour force has not increased everywhere



Source: Eurostat, ING Research

And hysteresis is further lowering the potential of labour

But estimating the labour supply is not sufficient to make a good assessment of the productive capacity as the labour market is sensitive to "hysteresis". This is a situation that arises when the long-term unemployed ultimately lose the necessary skills to stand a chance on the labour market. Since 2008, the number of long-term unemployed in the Eurozone has increased significantly, especially when you add the discouraged who have stopped looking for work. Certainly, the long-term and discouraged unemployed group has been shrinking since 2014, but it is still 39% larger than in 2008.

It would be too pessimistic to suggest that all these people are lost forever to the labour market, as structural reforms might make a difference in this regard. That said, some hysteresis cannot be excluded. Looking at labour as a restraining factor to production, it is striking to see that the percentage of businesses in both services and industry reporting a tighter labour market is now at a higher level than at the beginning of 2008, although the unemployment rate is still significantly above 2008's level. This would indeed point to an increased mismatch in the Eurozone labour market hampering potential growth.

1 https://www.ecb.europa.eu/pub/pdf/scpops/ecbop156.en.pdf

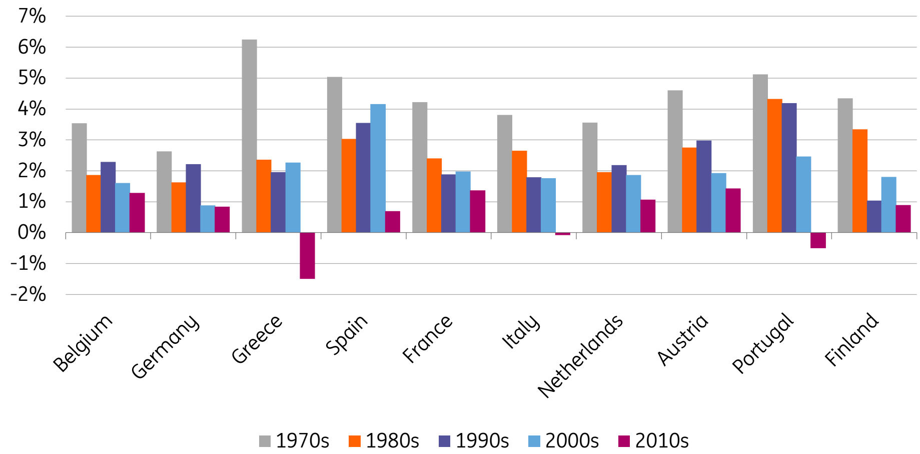
Capital destruction

The financial crisis resulted in a credit shock that caused investment in the Eurozone to plummet. Investment only bottomed out five years after its peak, which was 17% below the level of 2008. Even though depreciation generally happens much slower than investment, the prolonged Eurozone crisis with several years of credit constraints has caused the total capital stock to fall in some countries.

Weak investment has brought down capital stock growth...

Between 1998 and 2007, the capital stock in the Eurozone increased by 22%, while it grew by just 7% between 2008 and 2017. In Greece and Portugal, the capital stock declined over this period, which had not happened since the start of the time series in 1960! In Italy, the capital stock peaked in 2012 and has declined since then, also recording the first declines in almost six decades. This confirms that capacity utilisation will reach higher percentages sooner in the post-crisis period, as capital stocks have been shrinking in some countries.

Fig 2 The capital stock has stagnated since the start of the crisis

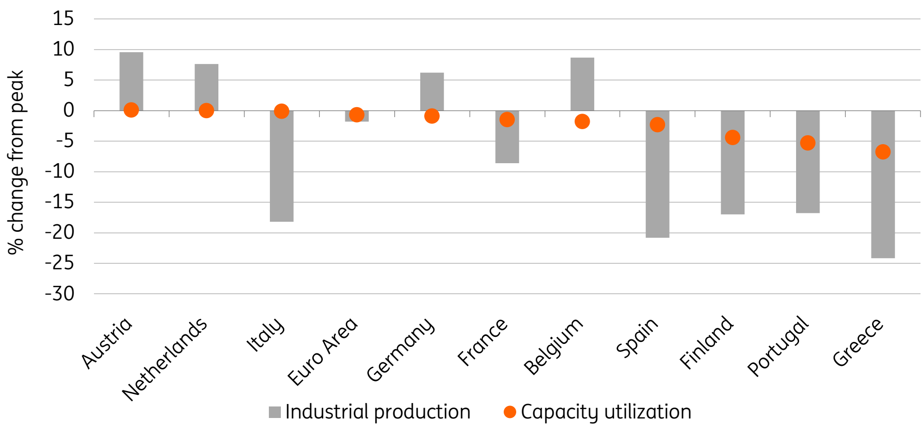


Source: European Commission AMECO, ING Research

And capacity constraints are returning at lower levels of production

Currently, 12.3% of businesses in the Eurozone industrial sector are reporting that a lack of equipment is constraining production. Capacity utilisation, a broader measure of capital use in the economy, is also nearing the peaks of 2000 and 2007 and well above levels experienced in the 1990s. This suggests that the limits of capacity are being reached quicker because of a lack of investment in capital during the crisis years. Figure 3 illustrates this by country. In Italy, manufacturing production is still more than 18% below its pre-crisis peak but capacity utilisation is just 0.1% below peak, testimony of the capital destruction during the crisis years.

Fig 3 Recovery in terms of asset types differs largely by country



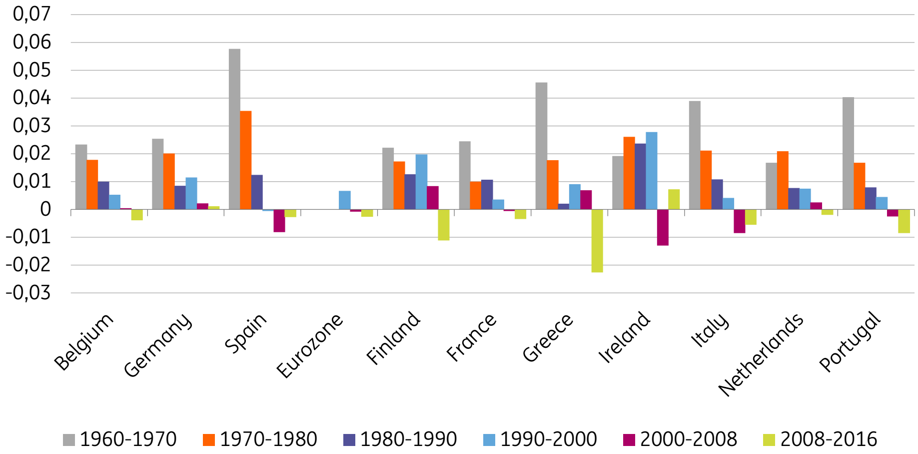
Source: Eurostat, European Commission DGECFIN, ING Research

Squandering resources

Productivity growth turned negative due to underused resources...

Even if growth in the labour force and the capital stock has remained subdued, productivity gains can still increase the potential output of the economy, the optimist would say. Bad luck, as growth in productivity has been on a declining trend for decades. The post-crisis period has been particularly poor, as Total Factor Productivity (TFP) growth has even turned negative. However, though the explanation for the drop in productivity is far from straight-forward, a large part of the story is that underutilisation of labour and capital because of the sharp drop in demand in the crisis years has caused productivity to drop. This has not been made up for by improved innovation or technological change causing capital and labour to be used more efficiently. To be sure, productivity growth doesn't need to remain at the current depleted level forever (in a future article we will go deeper into the factors that might lead to a somewhat more upbeat view on this).

Fig 4 TFP growth has been falling for decades and turned negative since the crisis



Source: The Conference Board Total Economy Database, ING Research

What does this mean for economic policy?

Therefore, the drivers of potential output over the past decade have been weak at best

For the years ahead, this means that substantial investment improvements are necessary to redeem the lost potential in some of the southern Eurozone economies. More particularly, investment in research and development would be most helpful as this could result in efficiency gains necessary to boost TFP growth. The focus on structural developments remains appropriate as the right improvements to the regulatory framework would lead to improved potential. Now that all Eurozone economies are growing, the timing seems appropriate as this makes reforms, generally speaking, less painful.

The lower potential output impacts room for fiscal spending negatively...

However, within the current European framework of monitoring public finances, the fact that potential output has been hit hard during the crisis years in a number of member states might paradoxically lead to a recommendation of even more austerity. If potential growth is thought to be weaker, it follows that the negative output gap in some member states might be smaller, implying that a bigger chunk of the budget deficit is thought to be structural, requiring additional austerity efforts. In that regard it will be worth following the debate in Italy, where the winners of the parliamentary elections seem to be willing to loosen fiscal policy.

For monetary policy, the concept of potential growth is also relevant, as a positive output gap might lead to inflationary pressure. However, the evidence of the link between a positive output gap and inflation is not very straightforward, as a recent working paper of the Bank of Canada demonstrates[2]. On top of this, there is lot of uncertainty regarding the real time estimates of the output gap, something Mario Draghi has emphasised on several occasions.

... and could cause a hike cycle by the ECB to be slower and less pronounced

Even with a good estimate of the output gap, the question for central bankers remains whether a positive output gap driven by lower potential growth has the same inflationary impact as a positive output gap driven by strong cyclical growth. As a matter of fact, lower potential growth would also mean that the neutral interest rate has come down.

For the ECB this could imply that once it starts hiking rates, it will have less opportunity to raise rates before causing an effective tightening. We therefore believe that when the ECB's tightening cycle begins, it will be slower and less pronounced than in the past, something not very dissimilar from what we have been witnessing in the US over the last few years. We expect a first rate hike in June 2019, with the interest rate on the ECB's deposit facility not reaching positive territory before 2020.

2 https://www.bankofcanada.ca/wp-content/uploads/2018/03/swp2018-10.pdf

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