EUROPEAN ECONOMICS

Medium-term european economic prospects

Lower growth, but a margin for improvement

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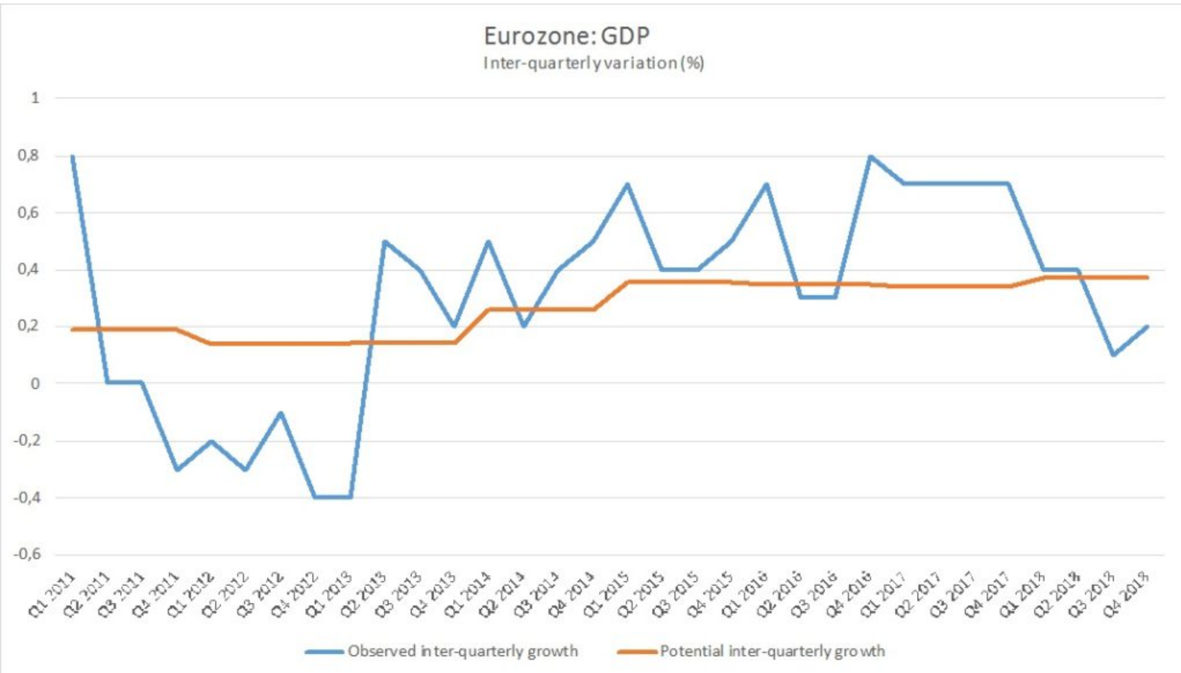
In this series of twor articles, the authors argue that the European Union (EU) Parliamentary elections come at a time of major present and future challenges. In particular, Europe needs to manage far-reaching economic changes, such as technological disruption, demographic transition and climate change. Furthermore, the challenge of migration, growing distances with the US, the rise of China and Russian revisionism all underline the importance of close European coordination and integration in foreign policy, defence and security. In this context, the question that arises is: how will Europe face the next five years?

Medium-term economic prospects: lower growth

Beyond short-term cyclical fluctuations, what can we expect from the European economy in the medium term? This question is particularly relevant given the deceleration in European economic activity in recent quarters and expectations of more moderate economic growth in the coming months (we expect growth in the eurozone to be below 1.5% for 2019, following on from 2.5% in 2017 and 1.8% in 2018).

Indeed, as shown in the first graph, European economic growth has been trending downward since 2017 and, in the last two quarters of 2018, fell notably below its potential for the first time since the 2012 sovereign debt crisis. The downward trend has largely been due to a series of adverse shocks (trade tensions, Brexit, strikes, weather and problems in the car industry, among others), but given the European economy's high sensitivity to these shocks, we need to examine just how strong the foundations for economic activity are. Looking to the future, we expect eurozone growth in the next few years to remain positive (thanks to solid internal demand) but moderate, lower than during the previous expansion cycle (2.2% growth from 2000 to 2007).

Furthermore, these risks are being underestimated. First of all, less external support, due to deceleration in global demand, will make it difficult for exports to return to the high levels of recent years. Secondly, political uncertainty is here to stay and will continue to predominate, whether due to Brexit or political polarisation. This trend can be seen in the uncertainty index created by Baker, Bloom and Davis for the eurozone: between 2017 and 2018 it stood at 215 points, a little higher than the 2013-2016 average (192) and much higher than the average for the previous expansion cycle (an average of 100 for 2000-2007).

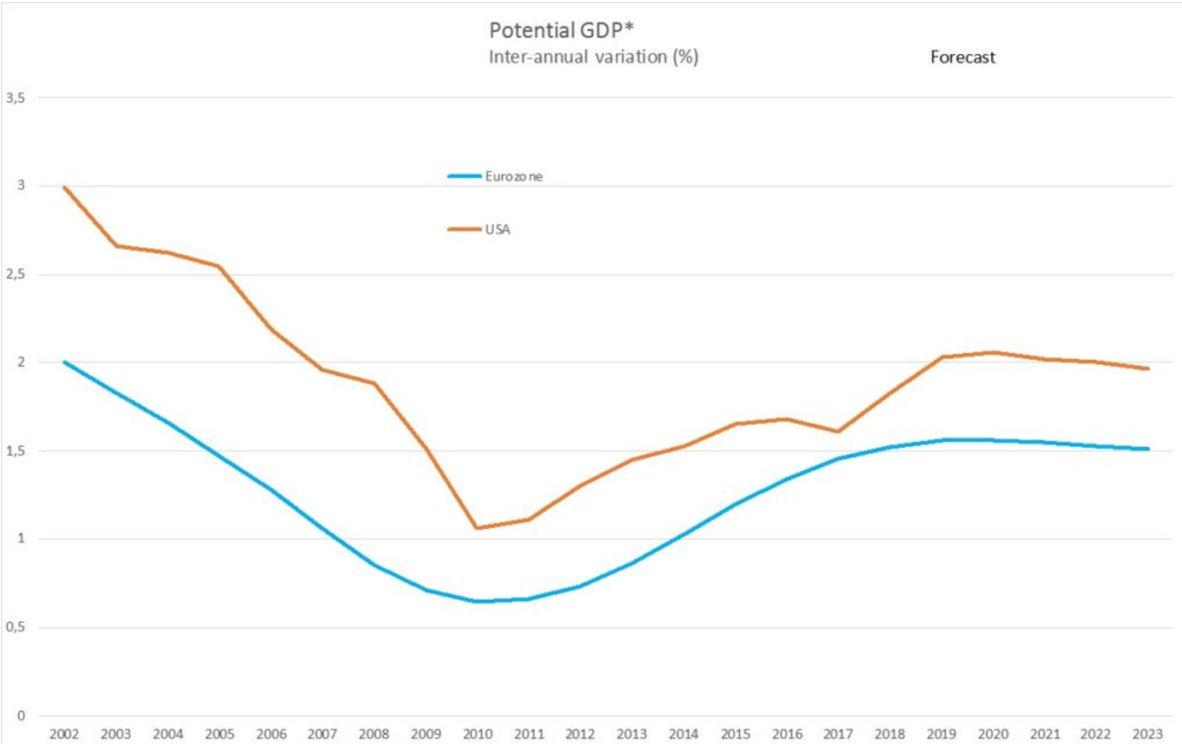


Source: CaixaBank Research, from Eurostat data.

A more detailed idea of medium-term economic prospects in the eurozone can be obtained by analysing potential GDP: what the European economy can produce sustainably, i.e. without generating pressures causing inflation to exceed its target and other imbalances. The second graph shows that, according to our estimates, potential eurozone growth over the next five years will be around 1.5%. This is significantly lower than during the pre-crisis period (a little over 2.0%) but also below expectations for the USA (1.9%).

What factors lie behind this pattern of moderate growth? The answer can be found in a series of structural factors that will limit medium-term growth. These basically involve changes in productivity, demographics, investment and a number of imbalances in the labour market.

Starting with productivity, according to European Commission estimates, average growth in total factor productivity from 2018 to 2020 will be 0.7%, but tending towards deceleration (although in line with the 0.73% for the last 20 years, excluding the crisis years) and below forecasts for the USA (an average of 1.1% from 2018 to 2028). In this context, one of the hurdles to dynamic productivity is its distribution: studies show that productivity increases in companies that are already more productive, but this does not filter through to the rest of the economy. [1]



Note: The author's own eurozone estimates based on a Hodrick-Prescott filter with eurozone economic growth data and forecasts from CaixaBank Research. US estimates from the Congressional Budget Office (CBO).
Source: CaixaBank Research, from CBO data.

With regard to demographics, the impact of an ageing population is already starting to be felt. Not surprisingly, it is estimated that the dependency [2] rate will rise by 5.4 points between 2017 and 2026 due to the retirement of baby boomers, reaching a figure almost double that of the 2009-2017 period. An ageing population will undoubtedly have an impact on economic growth due to a shrinking labour force. Furthermore, this phenomenon could also reduce growth in European productivity, measured as total factor productivity. [3]

With respect to investment, this is one of the components that has proved most dynamic in economic recovery. Nevertheless, its growth is expected to slow in coming years (after growth of 3.3% in 2018, the ECB forecasts growth of 2.2% for 2019-2021, 0.6 points lower than for the 2000-2007 period) due to the moderate impact of geopolitical uncertainty in business confidence and the gradual tightening of financial conditions.

Finally, structural unemployment in the eurozone is expected to remain relatively high (the

European Commission forecasts a rate of 7.8% for 2020). The fact that this contrasts to companies' increasing difficulties in filling vacancies with suitably qualified workers is a symptom of imbalances in the supply and demand of skills in the labour market, which could limit future production: in 2030, only 36.5% of EU workers will be highly qualified, but 4 out of 5 new jobs are expected to require high levels of qualification, largely due to the process of technological change. [4] Thus the importance of improving workers' human capital.

Analysis of eurozone risk absorption mechanisms

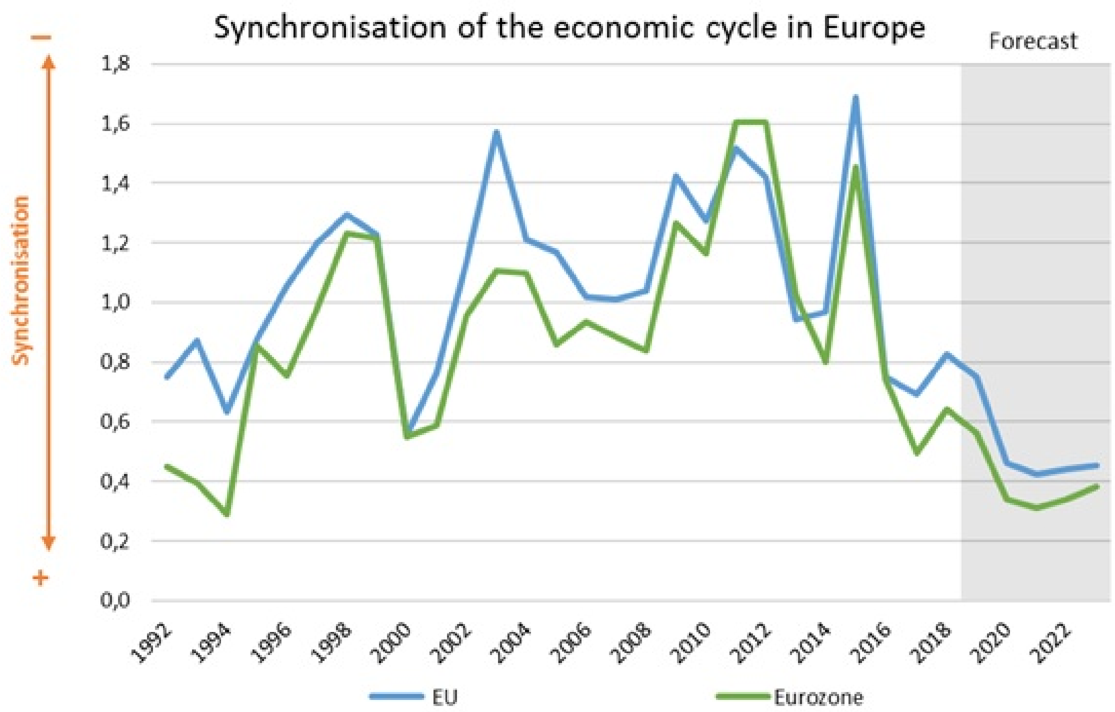
Over and above potential growth, it is important to analyse the ability of the eurozone to face the coming years and successfully handle the next recession. As will be seen, significant progress was made after the crisis, however this is likely to be very slow in coming years due to the slow rebuilding of buffers in their different dimensions (fiscal, external positioning, monetary policy) and an incomplete institutional design (for a thorough analysis of this factor, see the following article "European integration: the next five years… and the following decades").

With regard to public finances, there has been a moderate drop in public debt (from 94% of GDP in 2014 to a European Commission forecast of 83% in 2020), thanks to economic growth and looser financial conditions (not due to greater fiscal consolidation), but it still remains high and above the safety threshold of 60% established in one of the Maastricht Treaty criteria. Furthermore, there is a great deal of variation between countries, and the public debt of most of the peripheral countries is over 90%, thereby reducing the margin for implementing anti-cyclical policies should they be necessary, especially given the lack of progress in greater fiscal integration.

With regard to the external position, the European Commission expects the eurozone to maintain an overall current account surplus of over 3% in the next two years, although once again this figure hides major differences: some countries (such as Germany and the Netherlands) have considerable surpluses, while the periphery, after a sharp correction, is mostly in a situation of balance. Hence, it is important for the peripheral countries to maintain competitiveness levels that allow them to consolidate their external surplus and thus reduce external debt.

Finally, with regard to monetary policy, it would be desirable to raise interest rates once circumstances allow it in order to provide the additional cushion of a cut in interest rates when the economic situation deteriorates. Consequently, maintaining current low interest rates for longer than necessary is inadvisable, even though monetary normalisation seems likely to progress very slowly and there will be little cushioning in terms of monetary policy.

High asymmetries in growth rates among different countries in the last economic crisis (see the fall in synchronisation in the financial crisis in the last graph) already highlighted the limitations to offering a common economic policy response that works for all. Unfortunately, incomplete reconstruction of the buffers and the lack of significant progress at institutional level suggest the capacity to absorb adverse shocks is still not strong enough, and the current pattern of growth will be vulnerable to new shocks if measures are not taken.



Note: Weighted total of the standard deviation for each country minus average EU or eurozone growth. The weighting method used was the weight of each country in terms of nominal GDP.
Source: CaixaBank Research, from IMF data.

Series: Europe facing the mirror

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