Roads to recovery

George Gelauff, Debby Lanser, Albert van der Horst, Adam Elbourne
The Great Recession 2008-2013

• Financial crisis:
  – Global imbalances
  – Risk perception
  – Complex and risky financial innovations

• Euro crisis:
  – International risks and national supervision
  – Banks and sovereigns: suffocating embrace
  – Consolidation

• 2014, where are we now?

• 2014-2023, what are the roads to recovery?
The title of this book suggests a stern warning. Yes, who could resist the strong-sounding and hard-hitting sound of the book? This could mean the end of the economic growth of the eurozone and the beginning of a new era of austerity and adjustment.

The book reviews the impact of the Great Recession and the potential for a second round of austerity. It goes on to show how the eurozone is now more vulnerable to shocks and how to recover.

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One objective, Three questions

Three questions:

• Setting the scene:
  – What can we learn from recent developments?
• Taking score:
  – What can we learn from other crises?
  – What is the damage?
• Building blocks:
  – Which challenges and risks are ahead?

One objective:

• Where will the Dutch economy head for in the next decade?
2014, the facts

• Low GDP growth, but at least the economy grows
• Low inflation, but still positive
• High unemployment, with first signs of decline
• High government debt
• Low interest rates, low CDS-spreads
• …
2014-2023, our assessment

• The economy is resilient, but demand remains fragile
  – in Europe and the Netherlands

• Resilient
  – productivity growth will resume
  – labour markets will return to equilibrium
  – recovery of the economy will weaken the deleveraging challenge

• Fragile
  – deleveraging may delay growth
  – consolidation may harm growth
  – credit supply may limit investment and consumption
Productivity will resume growth (after a permanent loss)

- Banking crisis are associated with large, permanent declines in productivity relative to the previous trend.

- Reproduction of Serra-Cexana in Chapter 4 of *Roads to Recovery*

- No evidence that banking crises have a long-run effect on the growth rate of productivity
What might explain losses in productivity?

• Mechanisms
  – low price of risk before crisis -> bubble
  – loss of skills during unemployment
  – less R&D (lower expectations)
  – more R&D (lower opportunity costs)
  – fiscal austerity

• Much unknown
  – Just as Great Depression, 1930s
Labour market will return to equilibrium

• When aggregate demand recovers,
  – employment follows suit
  – unemployment returns to the natural rate
  – discouraged workers return

• Hysteresis: no evidence
• Scarring (loss of skills): some evidence

• The Great Recession does not permanently affect labour supply, but may have affected the human capital of the long-term unemployed
Unemployment, actual and NAIRU
Deleveraging $\leftrightarrow$ economic growth

- Economic growth may limit need to deleverage
  - limited decline of households wealth
  - assets still higher than liabilities
  - nominal growth may inflate debt problem
  - doesn’t harm recovery

- But, deleveraging may harm growth
  - indicators point at deleveraging
  - households and government (and firms) may all decide to save
  - weakening demand and nominal growth
  - aggravating deleveraging challenge
Indicators pointing at deleveraging
Consolidation may harm growth

Consolidation required to reduce government debt to 60% of GDP or to a sustainable level.

OECD 60%  EC sustainability
Credit supply may limit investment

Credit restrictions reported by SMEs

% respondents

- Refused because costs too high
- Rejection
- Only got a limited amount
- Did not apply because of possible rejection
Three roads to recovery
Economic growth

Structural supply
- Strong
  - Strong
  - Sufficient
  - Limited

Demand
- Strong
  - Strong
  - Sufficient
  - Limited
- Limited
  - Weak
  - Weak
  - Limited

Output gap
- Closed
  - Negative

Scenarios
- Accelerating Recovery
- Moderate Recovery
- Delayed Recovery

Limited

Negative
Three roads to recovery

• The economy is resilient, but the recovery of aggregate demand will take time.

• Depending on strong or weak supply, over the next decade the European economy may grow by 1½% (Moderate Recovery) to 2¼% (Accelerated Recovery) per year.

• When substantial demand risks materialise the economy will not recover in the coming decade and government debt deteriorates (Delayed Recovery).
### Three scenarios, 2014-2023

<table>
<thead>
<tr>
<th></th>
<th>accelerating recovery</th>
<th>moderate recovery</th>
<th>delayed recovery</th>
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<tbody>
<tr>
<td><strong>Gross domestic product, Euro area</strong></td>
<td>2¼</td>
<td>1½</td>
<td>1</td>
</tr>
<tr>
<td><strong>Gross domestic product, USA</strong></td>
<td>3¼</td>
<td>3</td>
<td>3</td>
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<tr>
<td><strong>World trade, weighted (for Nld)</strong></td>
<td>6¼</td>
<td>5</td>
<td>3</td>
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<tr>
<td><strong>Inflation, euro area (ultimo)</strong></td>
<td>2¼</td>
<td>1¾</td>
<td>1</td>
</tr>
<tr>
<td><strong>Interest rate, euro area (ultimo)</strong></td>
<td>4¼</td>
<td>4</td>
<td>2¼</td>
</tr>
</tbody>
</table>
A newborn spring and a newborn sound:
I want this song like piping to resound
that oft I heard at summer eventide
in an old township, by the waterside –
the house was dark, but down the silent road
dusk gathered and above the sky still glowed,
and a late golden, incandescent flame
shone over gables through my window-frame.

Gorter, Mei (May), 1889