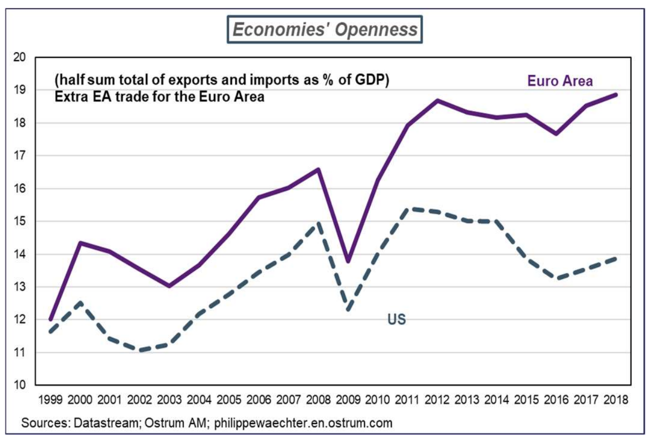
Euro area growth projections downgraded, and policy mix still restrictive
My weekly column

The OECD and the ECB have downgraded their 2019 growth projections for the euro area in quick succession, with the OECD now expecting 1% for the year ahead vs. 1.8% previously, and the European Central Bank projecting 1.1% vs. 1.7% in December, putting euro area growth below its potential pace.
The main reason for this rapid slowdown of the activity lies in the rapid deceleration of world trade, particularly in its Asian component. The White House policy is a key explanation of this trend change. This external shock profoundly modifies the equilibrium of the euro zone economy.

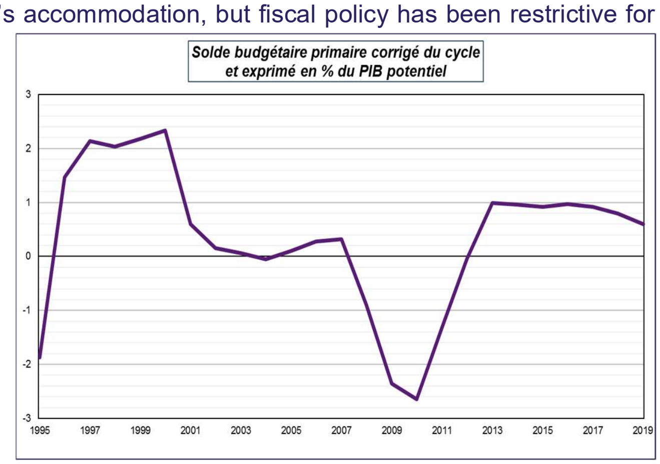
The OECD believes that the economy in the bloc has now become a source of concern for the world economy as a whole. Beyond the euro area's actual situation, a slowdown in the zone along with a sharp and swift downgrade to growth projections for 2019 also make for a shock on world growth. The area is a major contributor to world trade momentum, so a drastic slowdown is an additional source of concern for the world economy.
It is worrying that the euro area is so large, but yet it is still at the mercy of international events with little capacity to react to them clearly. It was buoyed by strengthening trade in 2017 but was dented by the recent negative shock, and its inability to absorb these tremors is alarming for the world as a whole and not just the European economy.

This situation reflects the fact that the area has become more and more open to outside influences, while for example the United States' exposure to trade with the rest of the world has remained steady over time. Germany plays a major role in this trend, as shown by the chart, while Italy and France are similar in terms of how open their economies are to trade with outside countries



The most surprising aspect during the current downgrades to growth projections is that this swift drop reflects the dearth of economic policy to cushion the shock.

The policy mix – i.e. the way fiscal policy and monetary policy work together – is restrictive. Financial conditions are admittedly encouraging as a result of the ECB's accommodation, but fiscal policy has been restrictive for too long and is not propping up economic activity, meaning that the shock from the world economy is in no way cushioned by euro area economic policy. The chart shows the primary budget balance (excluding interest payments) adjusted for the economic cycle and expressed as a % of potential GDP. This figure is an indication of how restrictive fiscal policy is, and in the euro area the balance is positive, pointing to restrictive policy.



The mistake that is being made on economic policy is keeping it restrictive at a time when potential growth is lower than in the past, and convergence towards this pace is further quickened by fiscal policy, as it fails to provide flexibility to address macroeconomic adjustment. This situation is further heightened in the event of an external shock, which is what is happening right now.

A very open economy with a positive primary balance is able to cushion a shock if fiscal policy is adapted to react to this shock and shore up domestic demand to buoy economic activity. Yet this type of strategy is unlikely in the euro area at this stage due to the Commission’s pledges on one hand, and the zone’s budget rules on the other. Action on fiscal policy also looks doubtful with the European elections just around the corner, as each party and each government in each country will want to promote its own economy rather than supporting a coordinated approach to drive the euro area.
Beyond the economic situation, we may well wonder about the need for a primary surplus at a time when potential growth is lower than in the past. With weaker demand to companies, they have little incentive to bolster activity and investment, so an increase in potential growth looks doubtful.

Furthermore, as I highlighted recently ("**Weaker productivity gains and shock on world trade**" on my blog from February 26, 2019), productivity gains are now sluggish. It is more difficult for the economy to recover in the event of a shock, and in this situation, having a primary budget surplus is the best way to restrict the economy. If we look at the previous chart, there is a clear aim to maintain a surplus, but when a shock hits, maintaining this fiscal discipline affects the allocation of resources and hits economic activity and jobs – this is precisely the risk the euro area is currently running if the external shock continues.
The euro area’s policy mix is poorly structured as ultimately the economy adjusts via activity and jobs, rather than the impact of a shock being tempered and spread out over time, which is precisely the role of economic policy. But if policy is overly restrictive all the time, then the economy adjusts instantly and hampers the private sector.
This is not the first time that the euro area’s policy mix has been ill-suited to the task. In 2011 this strategy had led to a long recession from mid-2011 to end-2012, and at the time, the ECB supported the Commission and hiked interest rates twice, in April and July 2011. Since the summer 2012, the ECB has tried not to restrict the economy when the economic situation is dicey.

One outcome of fiscal policy is that – for such times as it is so restrictive – the ECB must offset this with low interest rates. It will only be able to hike rates when fiscal policy becomes more accommodative in the long term or if there is a shock on productivity. In this respect, and in light of the struggle for technological leadership between the US and China with Europe merely looking on, we should not expect a productivity shock that would miraculously solve all the area’s problems.
We should expect interest rates to stay low for a very long time to come, although elections to the European Parliament in May could change the political balance in Europe, weaken Germany slightly – which has spearheaded the strong opening to outside trade and restrictive fiscal policy – and thereby set the stage for the beginnings of coordinated policy. But let’s not get carried away.

In the meantime, the ECB is maintaining accommodative policy, albeit to a slightly lesser extent than in 2018 as QE has already come to an end. The fresh TLTRO program will extend the existing set-up with the sole aim of avoiding a shock to the economy.
The OECD is salving its conscience by conducting its umpteenth model of the potential effects of more coordinated fiscal policy, seeking ways to make the economic system more efficient. Active fiscal policy would have an effective impact, but it’s uncertain whether this would go much beyond the very interesting statement from the OECD.
The way the euro area has been set up means that it does not have the political dimension required – living together is a commendable goal but living better is a much more ambitious target that does not seem to be shared by all.

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