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Fiscal Crisis III:
Will consolidation kill the eurozone recovery?

Allianz

WILL CONSOLIDATION KILL THE EUROZONE RECOVERY?

Question marks over the continuation of the global economic recovery have appeared in recent weeks. China's economic policymakers are attempting to curb buoyant business activity, optimism among Chinese companies is dwindling. In the USA there are mixed signals on the domestic economy, with labor market and housing data largely disappointing. Europe is dogged by the debt crisis, with its impact on the direction of fiscal policy. What is more, the G20 countries are still at odds about the right way forward for economic policy. Although US criticism of the German austerity package has faded since the G20 summit of 27/28 June, the "growth-friendly fiscal consolidation" planned by the industrial countries among the G20, without controls and sanctions, is not legally binding. Some Anglo-Saxon critics have already pinpointed the European austerity packages as the cause of a new recession. In the words of George Soros: "Europe faces almost inevitable recession next year and years of stagnation as policymakers' response to the euro zone crisis caused a downward spiral".

This discussion overlooks the fact that, quite like in the US, fiscal policy in Germany in 2010 is very expansionary and quite a few of the expansionary measures (above all the tax cuts) will remain in place beyond 2010. Even with the agreed austerity package (2011: 0.4% of GDP), the fiscal impulse in 2011 is substantially higher than in 2008.

On average, the austerity packages agreed in the eurozone since the end of last year add up to approximately 0.5% of GDP in 2010 and 1% of GDP in 2011. The headline consolidation figure in Greece of around 8% of GDP has only a limited impact on the eurozone as a whole given Greece's low share in overall GDP (around 2½%).

The impact of fiscal contraction on the economy is hotly disputed, but estimates of the fiscal multipliers broadly pan out at 0.5-1. Assuming the mid-range figure of 0.75, the austerity packages are likely to reduce eurozone GDP by 0.8-0.9 percent in 2011 (compared with a reference scenario without consolidation). The direct demand effects via lower public-sector wages, transfer payments or building investments are not sufficient to justify the forecast of a recession, unless other factors exacerbate the drag on the economy. Moreover, there are positive effects which cannot be captured in any calculations: Expectations among private households and corporates concerning the sustainability of public finances will improve and the uncertainty will be reduced. And presently there is another counter-effect from the lower euro. Since the end of last year the euro has fallen on average by a good 10%, not only against the dollar but against all major trading currencies. This increases corporate price competitiveness and boosts export demand. Of course, higher import prices push up inflation, eating into purchasing power. But, on balance, our econometric estimates show positive effects from a sustained 10% euro depreciation of 0.8-0.9% of GDP after two years.

Impact of a sustained 10% depreciation of the euro on the real economy

	after 4 quarters	after 8-12 quarters
Real exports*	+1.1%	+1.4%
Real imports*	-0.2%	-0.2%
Real private consumption*	-0.3%	-0.25%
Real GDP		
Gross effect**	+1.0%	+1.35%
Net effect**	+0.6% to +0.7%	+0.8% to +0.9%

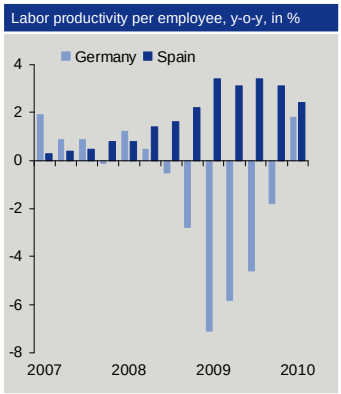
* Effect as a proportion of GDP.
** Gross effect: without deducting demand reflected in additional imports.
Net effect: after deducting demand reflected in additional imports.

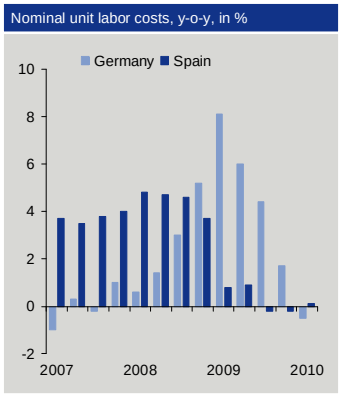
Consequently, the negative demand effects of the austerity packages and the positive effects of the euro depreciation could balance each other out, at least if the lower valuation of the euro persists.

Of course, it cannot be the objective of European economic policy to strive for a lower external valuation of the euro to stimulate the economy. This could erode confidence in the currency and would exacerbate the US deficit problem. On the contrary, in the midst of the debt crisis in a number of eurozone countries that has badly damaged international confidence in the euro, it is essential to restore this confidence as quickly as possible to prevent the euro from tumbling further. This calls for action at both the European and the national level. The Stability and Growth Pact needs to be reinforced, requiring the right to intervene at the European level in the fiscal policy of heavily-indebted countries. These countries must demonstrate their determination to rein in borrowing and get a grip on their external deficits by boosting competitiveness.

There are indeed already encouraging signs that the affected eurozone countries are making initial headway. In the early months of this year new borrowing in Greece, Ireland, Portugal and Spain has been broadly in line with the consolidation targets staked out for 2010. On the external side, the progress is particularly marked in Spain where the current account deficit is already well down on its 2008 level. This is doubtless being helped by the fact that labor productivity in Spain has risen sharply since 2008 despite the economic crisis whereas German labor productivity has plummeted.

Spain's adjustment process under way
Labor productivity and unit labor costs looking healthier





Source: Eurostat.

Of course, further adjustments in wages, productivity and credit markets are necessary, as are specific structural reforms in all the countries of the currency union. There is still a long haul ahead and some adjustments will cause pain. But if the public-debt crisis speeds up progress in these areas, it may in the end actually benefit overall eurozone competitiveness and turn out to be an unexpected blessing in disguise.

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