Economist Insights

Beyond potential

Troubles in EMs have made markets worried about their contagion to DMs. As a consequence many expect the ECB to loosen monetary policy as early as this week. So far the recovery in the Eurozone has held up relatively well. But given the large output gap in the Eurozone, the issue is whether the recovery is strong enough to prevent further damage to potential GDP growth.

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The market is now taking it as a given that emerging markets (EM) are in trouble, with the greatest focus on China. What it is now wondering is how much of this trouble will spread to developed markets. It is not just markets; the Federal Reserve delayed its September rate hike because of concerns about the international economy. If the troubles in EM are enough to turn the Fed more dovish, will other central banks follow?

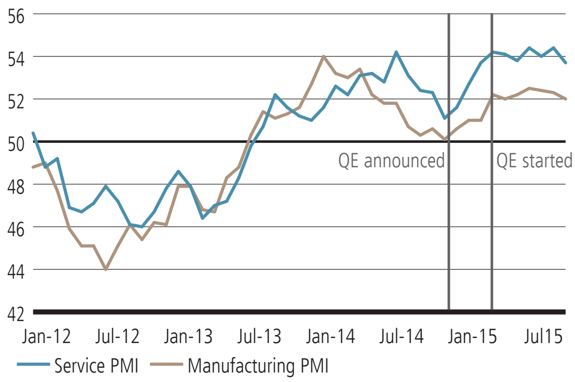
The European Central Bank (ECB) is not even considering a rate hike, but if they turn more dovish could this make encourage them to loosen monetary policy further? The market is looking for the ECB to do something as soon as this week's meeting. A cut in the deposit rate to even further negative is possible, but perhaps more likely might be an extension of their quantitative easing programme (QE).

Does the data back up further easing? So far, there is some evidence that weaker demand in EM has hurt Eurozone exports. But this external weakness has been largely offset by stronger domestic demand (consumer spending), as consumers benefitted from the drop in oil prices that accompanied the EM slowdown (see *Economist Insights,* Side Effects, 28 September 2015).

Despite slipping slightly in recent months, economic indicators for the Eurozone have held up pretty well latterly. The purchasing manager indices (PMIs) for both manufacturing and services each point to expansion and are slightly above their historical averages (chart 1). The turning point came just before QE was announced by the ECB. The upturn may or may not be connected to the anticipation of QE (the market and media were widely discussing it). But the ECB cannot fail to be disappointed that the improvement in the PMIs stalled in the wake of QE. After all, one of the main purposes of QE is to raise expectations of future growth.

Chart 1: Prudent Momentum Indicators

Eurozone manufacturing and service PMI (above 50 signals expansion, below 50 contraction)



Source: Markit, European Central Bank

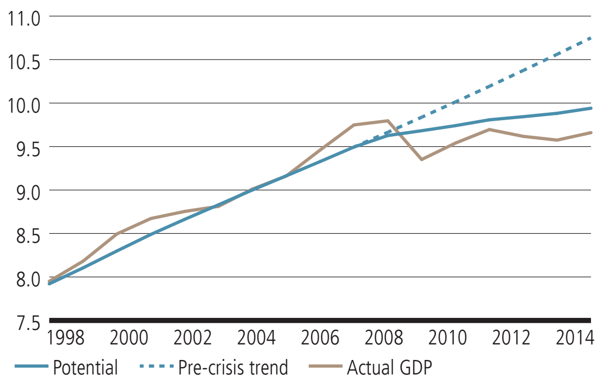
There may be green shoots of recovery in the Eurozone, but they are very slow to sprout into fully-fledged growth. The tentative nature of the Eurozone recovery makes it more vulnerable to external shocks, should the problems in EM worsen further. Given oil prices are already low, it will be hard for a further fall in oil to come to the rescue again.

If the Eurozone was simply growing slowly after a period of strength, there would not be much for the ECB to worry about. But the Eurozone is only just now starting to recover from two successive shocks: the financial crisis and the sovereign crisis. The level of growth is starting out from a much lower point than the ECB would ideally want, especially in the face of such an uncertain external environment.

The two successive crises not only hurt GDP, they also damaged the Eurozone's potential GDP. After the crises, investment spending fell sharply which means that the stock of productive capital is less than it would have been. Many people became long-term unemployed, especially in periphery countries. The long-term unemployed often see a drop in productivity as their skills become out of date. According to estimates from the European Commission, potential GDP is growing at half the pre-crisis trend (chart 2). Yet despite this big decline in potential, the actual level of GDP fell so much that it remains below the total.

Chart 2: Behind potential

European Commission estimates of Eurozone potential GDP, and extrapolation from pre-crisis trend, EUR trillions (constant 2010 prices)



Source: European Commission, UBS Asset Management

So there is still a negative output gap, implying lots of spare capacity. There are two ways the output gap can close: either happily as growth improves, or unhappily as potential growth declines. This unhappy outcome is possible: spare capacity is at risk of being destroyed if actual GDP growth remains low in coming years. Or to put it another way, if the negative output gap persists for too long, investment will fall and unemployment will persist, reducing potential growth.

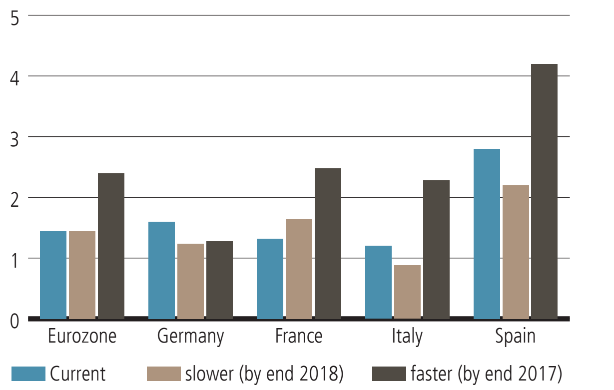
So how does the Eurozone go about reaching the happy outcome of closing the output gap without causing further damage to potential GDP growth? Actually, at the current pace of GDP growth the Eurozone should be able to close the output gap in about three years (chart 3), assuming there is no damage to potential output in the interim. For some countries in the periphery, the output gap could be closed within three years with lower growth. This is not such good news as it would first appear. It has less to do with rapid growth rates and rather more to do with the fact that many of these countries suffered huge drops in potential growth following the crises. In some countries potential growth is estimated at just 1%.

If the ECB wants to close the output gap over two years rather than three, they would need to do a lot more to boost near term growth. There is good reason to aim for this: it is not just potential growth that can be damaged by periods of weakness. Inflation expectations could start to fall as people become used to low inflation and the ECB loses credibility, making it harder to reach their target in the future.

A two-year horizon for closing the output gap (and hence boosting inflation) is probably what the ECB had in mind. After all, the Fed and the Bank of England both finished QE about two years ago, but are now considering rate hikes. In short, closing the output gap quickly would also allow a start to progressive interest rate normalisation beginning in 2017. But for that to even be a possibility the ECB will probably have to step up its QE programme; either that or keep its fingers crossed that EM are not doing as badly as the market thinks.

Chart 3: Reaching potential

Actual GDP growth and required GDP growth to close the output gap by the end of 2017 and 2018 without any further fall in potential GDP growth (%)



Source: Eurostat, UBS Asset Management
Note: Actual growth refers to 2015 Q2 apart from Spain where it was set equal to 0.7% and France to 0.3%. Potential growth was estimated using a band pass filter. The lower bound for potential growth was set equal to 2015 Q2 apart from Italy where it was set equal to zero (instead of slightly negative).