Medium-term outlook for the European economy: lower growth, but with room for improvement

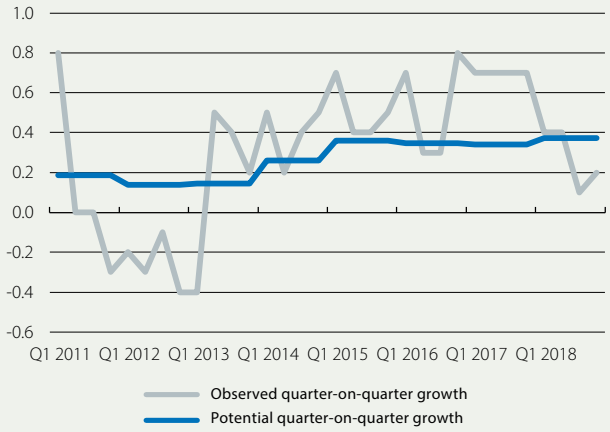
- **Euro area growth will be lower over the coming years than in the previous expansive cycle.**
- **There are structural factors (low productivity, population ageing and imbalances in the labour market) that will limit the medium-term economic outlook.**
- **The buffers of the euro area have improved since the financial crisis, but the persistence of certain imbalances will hamper their full reconstruction.**

Medium-term economic outlook: lower growth

Beyond the cyclical fluctuations in the short term, what can we expect from the European economy in the medium term? This question is particularly important given the slowdown in economic activity in recent quarters and the expectation that the euro area will continue to grow at a more moderate pace over the coming months (we expect it to grow below 1.5% in 2019, after the 2.5% of 2017 and the 1.8% of 2018).

Euro area: GDP

Quarter-on-quarter change (%)



Source: *CaixaBank Research, based on data from Eurostat.*

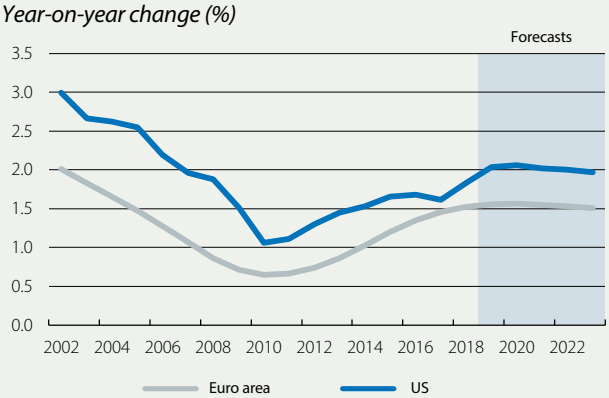
In fact, as we can see in the first chart, the growth of the European economy has followed a downward trend since 2017, and in the last two quarters of 2018 it has stood considerably below its potential, something not seen since the sovereign debt crisis of 2012. This downward trend has been largely driven by a spate of adverse shocks (trade tensions, Brexit, strikes, meteorology, problems in the automotive sector, etc.). Nevertheless, faced with the high sensitivity that the European economy has shown to such shocks, we must analyse how solid the foundations on which the economic activity stands really are. Looking to the future, we expect euro area growth over the next few years to be positive – thanks to the strength of domestic demand – but moderate, standing below that of the previous expansive cycle (growth of 2.2% between 2000 and 2007).

In addition, the risks are skewed to the downside. On the one hand, the reduced support of the external environment, due to the slowdown in global demand, will make it difficult for exports to grow at high rates in the next few years. On the other hand, political uncertainty has come to stay and will remain ever present, whether due to Brexit or political polarisation. This trend can be observed in the evolution of the uncertainty index built by the academics Baker, Bloom and Davis for the euro area: between 2017 and 2018 it stood at 215 points, somewhat above the average for 2013-2016 (192) and well above the average of the previous expansive cycle (100 points on average in 2000-2007).

In order to assess the medium-term economic outlook for the euro area in more detail, a good guide is its potential GDP: what the European economy can produce in a sustainable manner, without generating pressures that drive inflation away from its target rate or cause other imbalances. In the second chart we can see that, according to our estimates, the potential growth of the euro area in the next five years will stand at around 1.5%. This is significantly lower than in the pre-crisis period (slightly above 2.0%), as well as being below our prediction for the US (1.9%).

Potential GDP *

Year-on-year change (%)



Note: ** Euro area estimates based on a Hodrick-Prescott filter, with economic growth data for the euro area and forecasts by CaixaBank Research. US estimates by the Congressional Budget Office (CBO).*
Source: *CaixaBank Research, based on data from the CBO.*

What factors lie behind this pattern of more moderate growth? The answer can be found in a series of structural factors that limit growth in the medium term. Essentially, these include the trends in productivity, demography, investment and structural imbalances in the labour market.

Starting with productivity, according to estimates by the European Commission, average growth in total factor productivity between 2018 and 2020 will stand at 0.7%, but with a decreasing trend (albeit in line with the 0.73% average rate for the past 20 years, excluding periods of crisis) and below that expected in the US (1.1% on average between 2018 and 2028). Following on from this, one of the factors holding back buoyancy in productivity is insufficient

diffusion: studies show that productivity grows in companies that are already more productive, but this does not filter down to the rest of the economy.[1]

With regard to demography, the impact of population ageing will begin to become apparent. Not in vain, it is estimated that the dependency ratio[2] will increase between 2017 and 2026 by 5.4 pps due to the retirement of the baby boomers, reaching almost double that of the period 2009-2017. Population ageing will have an unquestionable impact on economic growth due to the reduction it entails for the labour force. In addition, this phenomenon could reduce the growth of Europe's productivity, measured in terms of total factor productivity.[3]

As for investment, it has proven to be one of the most dynamic components during the economic recovery. Nevertheless, its growth is expected to slow down in the next few years (following growth of 3.3% in 2018, the ECB expects it to grow by 2.2% in 2019-2021, 0.6 pps lower than the growth of 2000-2007). This is due to a moderate impact of geopolitical uncertainty on business sentiment and a gradual tightening of financial conditions.

Finally, structural unemployment in the euro area is expected to remain at relatively high levels (the European Commission projects a rate of 7.8% in 2020). This is in contract to the increasing difficulties that firms are experiencing to fill their vacancies with suitably qualified workers – a symptom of mismatches between the demand and supply of skills in the labour market. Such mismatches can limit production in the future: in 2030 just 36.5% of EU workers will be high-skilled, yet it is expected that 4 out of every 5 new jobs created will require a high level of qualification, largely due to technological change,[4] hence the importance of improving the human capital of the workforce.

Synchronisation of the business cycle in Europe

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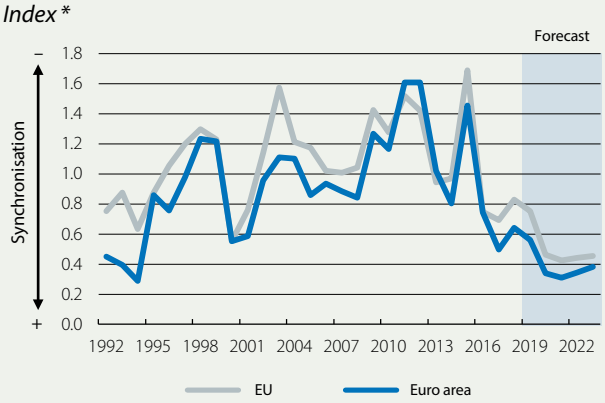

Note: ** Weighted sum of the standard deviations of each country less the average growth of the EU or the euro area. As a method of weighting, we use each country's weight in terms of nominal GDP.*
Source: *CaixaBank Research, based on data from the IMF.*

Analysis of the euro area's mechanisms to cushion the risks it faces

Besides growth potential, it is important to analyse the euro area's ability to address the next few years and be well equipped to tackle the next recession with guarantees. As we shall see, significant progress was achieved after the financial crisis. However, looking ahead to the next few years, we face the prospect of veryslow strides due to the fact that the different buffers (fiscal, external position and monetary policy) are being rebuilt slowly and hampered by an incomplete institutional design (for a comprehensive analysis of this factor, see the following article «European integration: the next five years... and the following decades» in this same Dossier).

In relation to the public finances, public debt has declined moderately (from 94% of GDP in 2014 to 83% in 2020 according to the European Commission's forecast), thanks to economic growth and accommodative financial conditions (not due to greater fiscal consolidation). Nevertheless, it remains high and above the 60% safety threshold laid down by one of the criteria of the Maastricht Treaty. Moreover, the disparity between countries is high and most peripheral nations have levels of public debt in excess of 90%. This reduces the margin for implementing countercyclical policies if necessary, especially in view of the lack of progress achieved in terms of greater fiscal integration.

As for the external position, the European Commission expects the euro area as a whole to maintain a current account surplus above 3% over the next two years, although this figure once again masks significant disparity: some countries (such as Germany and the Netherlands) have considerable surpluses, while the countries of the periphery, following a major correction, are closer to an equilibrium. In this regard, it will be important for the peripheral countries to maintain levels of competitiveness that enable them to consolidate their external surpluses and thus reduce their external debt.

Finally, in monetary policy, it would be desirable to raise interest rates when the circumstances permit it in order to have an additional buffer that allows rates to be reduced when the economic situation worsens. Therefore, it is inappropriate to keep rates as low as they currently are for longer than is absolutely necessary. However, all the indicators suggest that the process of monetary normalisation will be very slow and that we will not be able to count on a big buffer in the sphere of monetary policy.

The high asymmetries in the growth rates between countries in the last economic crisis (see in the last chart the fall in the level of synchronisation during the financial crisis) already highlighted the limitations for providing a common economic policy response that could work on a widespread basis. Unfortunately, the incomplete reconstruction of the buffers and the lack of substantive progress at the institutional level suggest that the capacity to deal with adverse shocks is not yet sufficiently robust and that the current pattern of growth will be vulnerable to the emergence of new shocks if no measures are taken.

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1. See D. Andrews, C. Criscuolo and P. Gal (2016). «The global productivity slowdown, technology divergence and public policy: a firm level perspective», Hutchins Center Working Paper.
2. Proportion of the population over 65 years of age compared to the working-age population between 16 and 64 years of age.
3. See S. Aiyar, C. Ebeke, and X. Shao (2016). «The impact of workforce aging on European productivity», IMF Working Papers.
4. See S. Chatzichristou (2018), «The future of skills: what does data tell us?», presentation by the European Center for the Development of Vocational Training.