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Hope For The Best Prepare For The Worst: The European Economy Spring 2014

07/04/2014 by Andrew Watt

The main message for European policymakers from the IMK (Macroeconomic Policy Institute) economic forecast last week is that while there are strong grounds to hope for the best, concrete steps need to be taken to avoid the worst. Let us start with the good news and then ponder the risks, before recommending appropriate policies.

A belated but broadening upswing

The European economy appears finally to have turned the corner. In the euro area the recession was overcome in the course of last year and employment has bottomed out. The IMK expects growth of 1% and 1.7% in the euro area in the current and coming year respectively. Thanks to faster growth in the UK, Poland and some smaller economies outside the common currency area, the EU as a whole will grow rather faster. Even in the crisis countries the signs are at last encouraging. Greece will continue to contract, on annual averages, this year but a substantial rebound is expected in 2015 (3.2%). Spain and Portugal will grow slightly below and rather above the euro area averages this and next year; unemployment is already falling, in Portugal rapidly. Meanwhile Italy continues to lag, stagnating this year and with sub-par growth in 2015 (0.8%).

The main drivers of this improvement are the easing of tensions on government bond and other financial markets and, in particular, the partial lifting of the austerity burden. A number of countries, notably France, have been given more time to bring deficits down, and Italy has been removed from the excessive deficit procedure. Government consumption will as a result no longer act as a drag on output, as it did with such disastrous results during the recession.

Serious downside risks

Three potentially significant downside risks are identified to this generally favourable forecast for the European and especially the German economy. One is that the geopolitical tensions with Russia over the Ukraine and Crimea could escalate, leading to the imposition of swingeing sanctions, or even military conflict. The probability and also potential outcomes of such a scenario are considered incalculable, however.

Two more insidious concerns are addressed more fully. The first is political. The incipient recovery notwithstanding, the economic and social situation in the crisis countries remains dire, with unemployment at historically high levels. Euroscepticism is also on the rise in many core countries. Political uncertainty is considerable, not least in the light of the forthcoming European elections. In short, negative shocks from the policy sphere cannot be ruled out and the political and institutional capacity to face them appears in doubt.

This interacts with a second crucial threat: deflation. Inflation is currently extremely low – the most recent monthly headline figure was just 0.5% – and has been on a persistent declining trend. Monthly figures for core inflation – consumer prices excluding energy, food, alcohol and tobacco – are consistently around half the ECB's inflation target of just under 2%. The negative output gap is large, unemployment still appallingly high.

The outlook has finally brightened, after a miserable and unnecessarily protracted crisis, but we are not out of the woods yet.