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GLOBAL MACRO & THEMATIC INDEPENDENT RESEARCH

November 4, 2012

GLOBAL MACRO

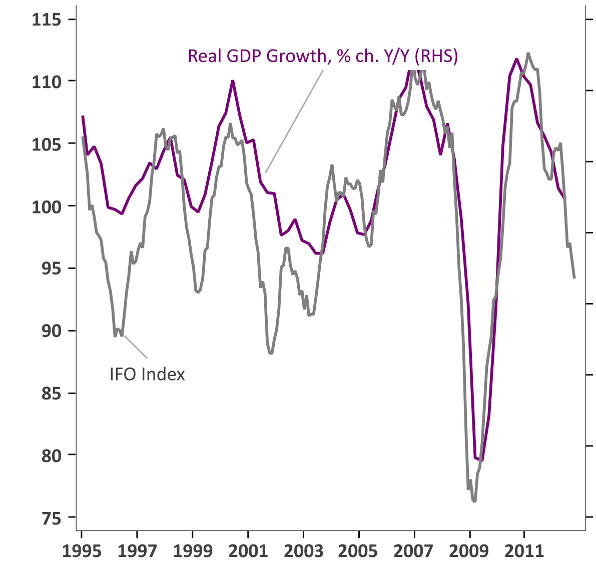
When the Eurozone Policy Mix Becomes a Weapon of Mass Destruction

Last week's economic data should have eliminated any lingering doubts about the state of the eurozone. The recession has definitely arrived in the single-currency countries—all of them. Although the third-quarter figures turned out to be slightly less bleak than suggested by surveys this summer, that doesn't alter the overall picture. In fact, the eurozone will probably pay dearly in the fourth quarter for the unexplained rebound in automotive output that drove the better-than-expected performance, since order backlogs have shrunk dramatically and automakers already plan to mothball significant production capacity in November.

Nor is Germany any better off today than its European peers. PMI and IFO surveys all point unambiguously toward the country's imminent slide into a recession (see "Recession for Everyone Germany Included" dated July 7, 2012). And the rest of the region will soon be feeling the knock-on effects.

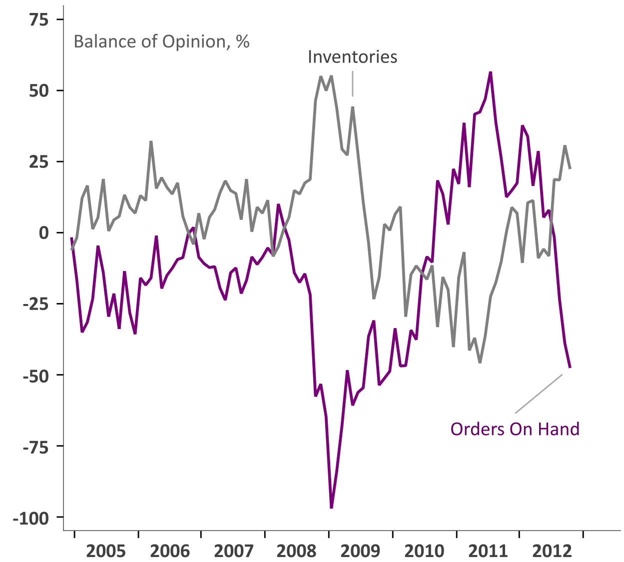
We certainly wish we had been wrong on this score, because the unfolding recession—which is unlikely to be countered with the kind of economic policy capable of cushioning the blow—is both unprecedented and profoundly disconcerting.

German IFO Business Climate and Real GDP Growth



Sources: RichesFlores Research, Macrobond

Order Book and Inventories of The German Car Industry



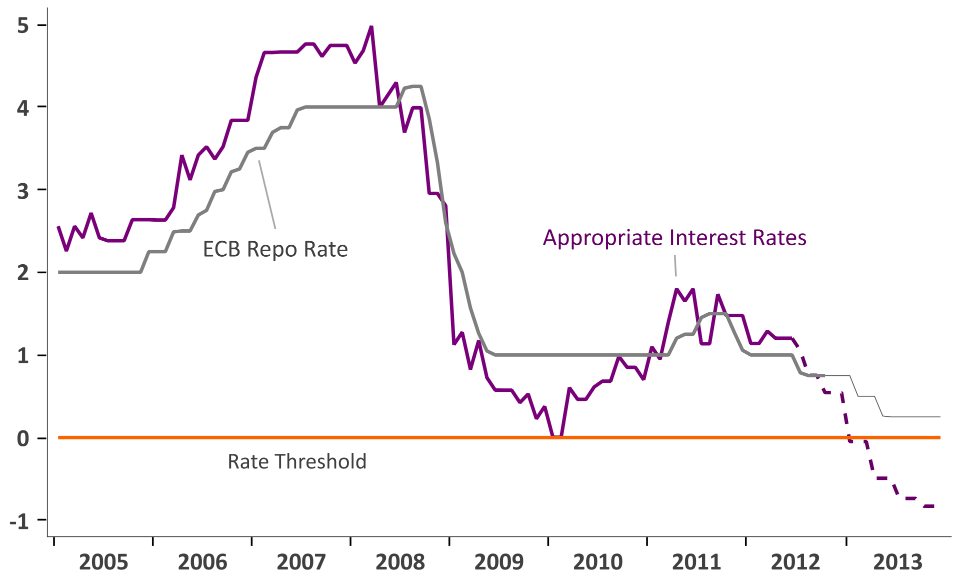
Sources: RichesFlores Research, Macrobond

The ECB's key rates should be cut to –1 percent to mitigate the recession.

Counter-cyclical policies are crucial to stemming the snowball effects set in motion by economic contraction. Without them, there is a serious risk of getting trapped in a lasting depression. Such economic policy responses traditionally have two main components: monetary easing; and leveraging the automatic stabilizers built into fiscal policy, reinforced in some cases by stimulus measures. By combining such actions, a country can alleviate the financial pressure it is exposed to while partially offsetting the revenue shortfall inevitably caused by a downturn.

It is worth recalling that after the onset of the 2001 recession, the ECB eventually lowered its key rates by a total of 275 basis points, and by a total of 325 basis points in response to the shock of 2008. Assuming no change in inflation, the adjustment engineered by central banks roughly matches the ex post variance in the real economy's growth rate over a given period. If this rule of thumb is applied to our forecast of a 1-percent contraction in eurozone GDP in 2013, then the ECB would need to adjust its key rates by some 250 basis points by the end of next year. A slightly more fine-tuned approach using the Taylor rule yields a fairly similar estimate, suggesting that with no change in inflation, an interest rate of –1 percent would be appropriate for our real GDP growth forecast. **But in any event, with key rates already down to 0.75 percent, such an adjustment simply isn't feasible.**

Appropriate Rates According to The Taylor Rule vs. Actual ECB Rate



Sources: RichesFlores Research, Macrobond

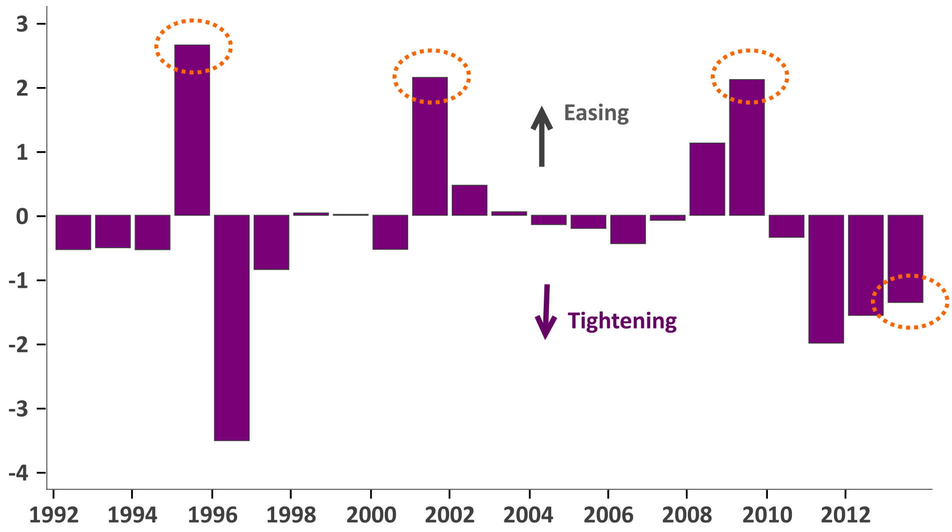
This situation wouldn't be so disturbing if not cutting interest rates could be considered a neutral monetary policy. Unfortunately, it can't. Interest rates in absolute terms are a less significant metric than the difference between them and the economic growth rate. Any increase in that difference would automatically reduce the demand for credit, and vice versa. **During a recession, simply maintaining interest rates at the same level therefore translates into a tighter monetary policy—which can be fully expected to amplify the recessionary trends currently under way.**

It would make more sense to reduce the cyclically-adjusted budget balance by between 1 and 2 percentage points than to increase it.

The big worry here is that fiscal tightening has already been adopted across the board. In 2013, current fiscal adjustment programs—most of them already incorporated into national budgets—can be expected to increase the cyclically-adjusted primary balance in EU Member States by 1.3 percentage points of GDP, according to the OECD. Yet it would make more sense to reduce the balance by between 1 and 2 percentage points during a recession so that automatic stabilizers can kick in. Such fiscal adjustment programs thus translate into additional tightening. With economic growth becoming increasingly sensitive to changes in the cyclically-adjusted primary balance as one country after another implements austerity measures, the average fiscal multiplier in the eurozone today is probably close to one. All other things being equal, we are looking at an additional shock that could shave anywhere from 2 percent to 3 percent off of eurozone GDP.

EMU Fiscal Stance, % of Potential GDP

Annual Change In Cyclically Adjusted Government Primary Balance

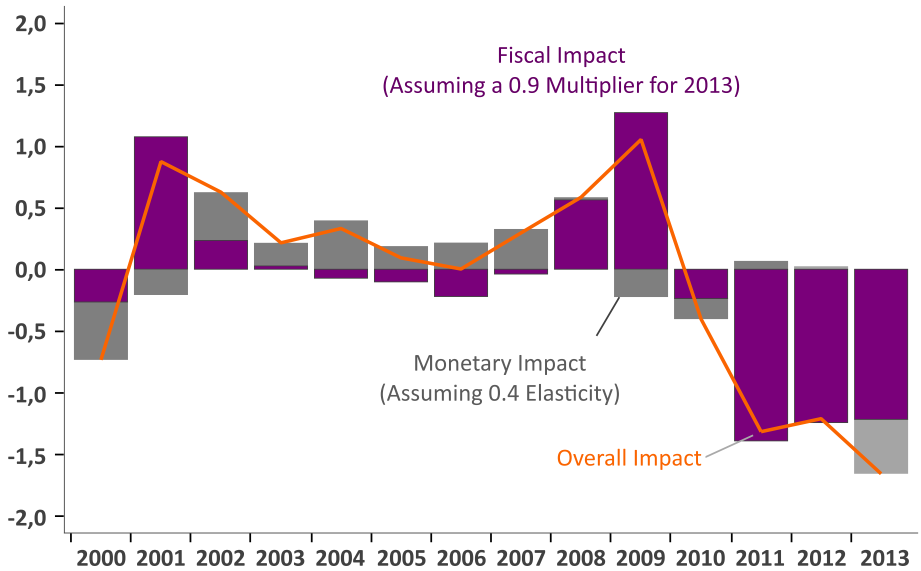


Sources: RichesFlores Research, Macrobond

Economic policy change will continue, but will it happen fast enough to work?

How high might the total bill ultimately be? Hard to say, because the crisis has changed the way in which economies respond to the interest rate and fiscal policy environment. But we should definitely brace ourselves for a serious jolt. **Our estimate is that all other things being equal, the current policy mix should on average cost up to 1.6 percent of eurozone GDP in 2013, plus more than one additional percent due to the absence of automatic stabilizers.**

Ex-Ante Impact of The Policy Mix on Eurozone GDP, %



Sources: RichesFlores Research, Macrobond

This means the bill will be far too steep for an already ailing euro area. **It also makes it crystal-clear that a shift in economic policy of the kind advocated at the start of the summer** (see "The Euro Area at the Crossroads" dated June 22, 2012) **is in the cards:**

- The ECB will use all the rate-cutting ammunition it has left.
- Germany will adopt a stimulus package, most likely before the winter is over.
- Changes will undoubtedly be made to the various fiscal adjustment timetables.
- Project bonds will be issued to finance EU infrastructure programs.
- Eurobonds will probably soon become a reality.

At this stage, the million-dollar question is whether such long-overdue changes still stand a chance of pulling Europe back from the brink in time.

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