# Economic Recovery in Europe?

*Michael Mussa says that while Asia surges economically, the recession appears to be bottoming out in Europe as well as the United States, but it is too soon to determine the strength of the coming global recovery.*



Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Michael Mussa, senior fellow at the Institute, is here to talk about the latest trends in the global economy. Thanks for coming, Mike.

Michael Mussa: My pleasure, Steve.

Steve Weisman: The news is that Europe is experiencing a recovery of sorts, which has taken some commentators by surprise. I'm asking you for a little bit of a preview of the World Economic Outlook presentation that you'll be making in a month at the Institute.

Michael Mussa: I think the evidence says that in Europe, the recession bottomed out in the second quarter. We had slightly positive GDP growth figures reported for France and Germany, still negative figures for the United Kingdom and Italy. So Western Europe as a whole [was] probably essentially flat in the second quarter of last year. In the US, of course, the estimate was 1 percent [contraction] in the second quarter so, again, bottoming out.

Asia seems to be ahead of the game. China already turned a positive growth clearly in the first quarter and a number of Asian economies reported—quite strongly—positive growth in the second quarter, reversing large losses at the beginning of the year.

Steve Weisman: Any way of telling from the numbers of what the growth will be in the next quarter or two?

Michael Mussa: No, we need to be careful. I mean, some of the spectacularly strong numbers for Singapore and so forth, are clearly deceptive. They are bouncing back from extremely negative numbers the quarter before. So I don't think we'll see more 20 percent growth rates on an annualized basis.

On the other hand, in Europe and the United States, I think we will see the slightly negative or slightly positive numbers turn more positive as we move through the third and fourth quarters of this year and in the next year.

Steve Weisman: Mike, you've often said that steep recessions are usually followed by steep recoveries. Do you see any evidence of that theory unfolding in reality in the latest numbers?

Michael Mussa: What we're seeing is certainly consistent with that view. But we're going to need at least a couple of more quarters to be able to say it's a steep recovery. What we know now is basically we've bottomed out and we have some indications that we're beginning to turn upward, but we don't yet have much of an indication of the strength of that recovery. I remain reasonably confident that we will have a recovery that is significantly stronger than is broadly anticipated by most forecasters. But I can't say the evidence, so far, either supports or refutes that notion.

Steve Weisman: I don't want to misrepresent the views of those who feel that the recovery will be anemic, but I believe they are saying that consumers will be cautious. The evidence already is that they're, in the United States, saving more, which is not a bad trend. And second, that the financial infrastructure is weak and that those will contribute to the weak recovery, in their view. What's the counterargument to that?

Michael Mussa: Of course, one argument is yes, that's true up to a point. So I'm not anticipating that the recovery in the US economy, in particular, will be as strong this time as following the recession of 1981–82 when in the first six quarters of the Reagan expansion, we got more than 10 percent cumulative GDP growth. I'm expecting around I guess something like 6.5 percent or 7 percent growth between the middle of this year and the end of next year. That's roughly double the growth that's in the average forecast but is below not only the Reagan recovery, but also most of the recoveries from the earlier deep recessions in the post-war era. So it's stronger than virtually any other forecast that's out there, but it's weaker than the average that we've seen following deep recessions.

Steve Weisman: Mike, what is the role of exports in this recovery? It's often said that the prosperity of the last several years has depended a lot on the American appetite for imports from other countries, and that that can't happen again and policymakers don't want it to happen again. What are the trends in especially Germany and Japan?

Michael Mussa: It varies from country to country. Actually, US import growth slowed quite substantially beginning in 2006. Now, of course the kind of bottom fell out at the end of last year, in terms of US imports, as domestic demand shrank as well, and that clearly impacted a number of other countries. Indeed, the US trade balance has improved during the recession while the trade balances of other countries have worsened.

Germany is particularly exposed to exports, and a large part of the recession in Germany is sort of a collapse of their export market. They export a lot of capital goods and they've been hard hit in the recession. So recovery in Germany is going to be particularly dependent upon recovery in their exports, and hence, on the recovery in the rest of the world. I think we will see that. So I think the German economy has reasonable prospects for recovery.

France, for example, is significantly less dependent on exports—particularly exports of capital goods and manufactured goods—than Germany is. And there, I think the recovery of domestic demand will play a key role. Again, the United Kingdom is different from the others. They've got problems with correction in the housing sector and also, pretty clearly, some continued shrinkage of their financial sector. So the story is mixed. Part of what we saw in a number of the Asian economies, the smaller ones, the rebound was a very sharp rebound in exports, particularly to China.

Steve Weisman: Speaking of housing and the financial sector, what's the trend there in Europe?

Michael Mussa: There isn't really a trend in Europe. You've got Spain, the United Kingdom, and Ireland, which have had many multi-year housing booms. And there, housing is in the dumpster. And at one point Ireland was—nearly 20 percent of their GDP was in residential investments. They're not going to go back to that. And Spain is not going to go back to 10 percent of GDP in residential investment and the United Kingdom, I think probably also will not see recurrence of the residential boom.

But there wasn't a big residential investment boom in France, Germany, Italy, and so forth. So that's much less of a factor in their recessions. I'm not expecting a big boom coming back, say, in contrast to the United States where we've depressed housing investments so much that at the bottom housing starts were less than a quarter of what they were at the peak. And even if we recover only a third of what has been lost in residential investment since the end of 2005 that will add an important amount to GDP over the next 18 months.

Steve Weisman: The Germans especially have resisted American appeals for stimulus spending on the order that the Obama administration initiated with the approval of Congress earlier this year. Does the recovery, or even the first signs of recovery, in Europe and especially Germany, vindicate the German opposition to the stimulus spending?

Michael Mussa: To some degree, but it's important to remember that the Germans actually implemented significant spending increases beginning late last year. Their resistance was mainly earlier in the year, because German unemployment rate still had barely risen at all from what was a multi-decade low. When the unemployment rate began to shoot up very rapidly last fall, then the German government sort of changed its tune on the desirability of stimulus.

Steve Weisman: And the European Central bank…

Michael Mussa: Similarly, the ECB, they were tightening until the early summer of last year and they clearly switched dramatically. The easing, they haven't gone quite as low as the Federal Reserve has. So I think there's no doubt part of what we're seeing in terms of the bottoming out of the recession is that policy has moved to a much more stimulative stance across Europe.

Now, not as much as in the United States but I think the Germans, you know, domestic spending, fiscal spending in Germany is not going to help their export industries particularly. So it makes less sense for them to engage in large-scale domestic spending, fiscal spending, when the problem is largely in exports, than it does conceivably in the United States where the weakness of demand is more domestically oriented.

Steve Weisman: It's almost exactly a month away, but what would you expect Chancellor Merkel of Germany to be telling her colleagues at the next G-20 meeting in Pittsburgh in late September?

Michael Mussa: I think that she will be, to some extent at least, celebrating the apparent end of the recession in Germany. And I think, in fact, all of them, possibly with the exception of Gordon Brown because the UK economy and Silvio Berlusconi, the Italian economy, haven't been doing that well yet. So I think she will be quite positive in her tone about Germany and about the world economy. This is going to be, I think, an optimistic tone, since I think the leaders, without overdoing it, don't get caught if things slow down again, will want to have a positive tone coming out, and that will include the German chancellor as well.

Steve Weisman: Mike Mussa, thank you. And we look forward to your more encyclopedic presentation on September seventeenth here at the Institute. Thanks again.

Michael Mussa: You're welcome.