

# Prospects and Challenges in the Euro Area

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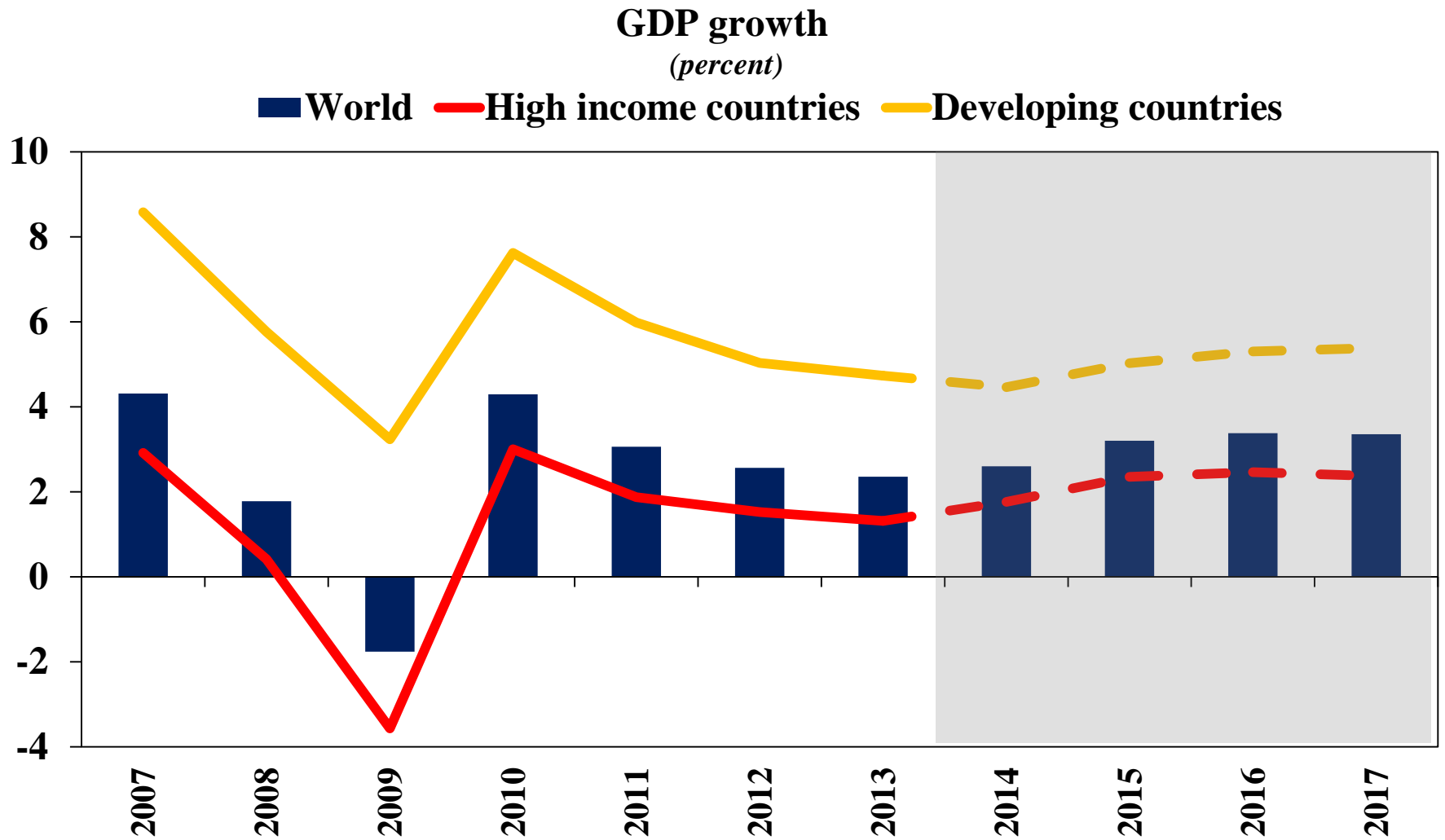
# Four Questions

1. What is the global economic outlook? *Slow recovery in the baseline but downside risks dominate*
2. What is the outlook for high-income countries and the Euro Area? *Diverging growth trends. In the Euro Area, weak growth, low inflation, and high unemployment*
3. How have Euro Area policies evolved recently compared to previous global recoveries? *Fiscal and monetary policies were aligned in previous episodes, but have diverged recently*
4. What lessons can the Euro Area draw from other crises? *Focus on growth through structural reforms; maintain flexible and credible fiscal policies; and recognize debt problems.*

# 1. What is the global outlook?

***Slow recovery in the baseline  
but downside risks dominate***

# Global Recovery: Still Weak and Slow

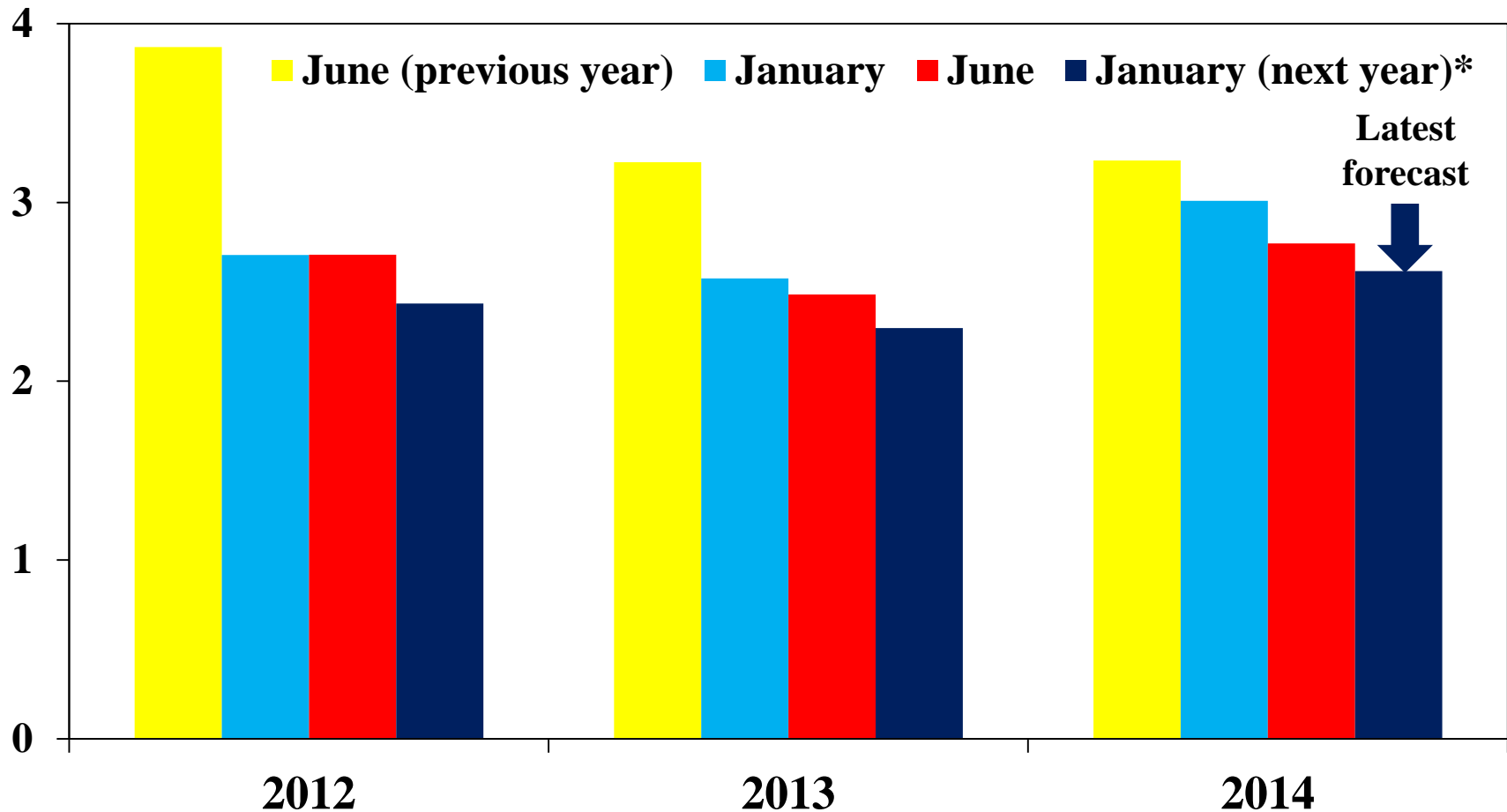


Source: World Bank.

Note: Dotted line and shaded area = preliminary forecasts (September 30) reflecting working assumptions

# Negative Surprises in Recent Years: History Repeats?

World GDP Growth Forecasts  
(percent)



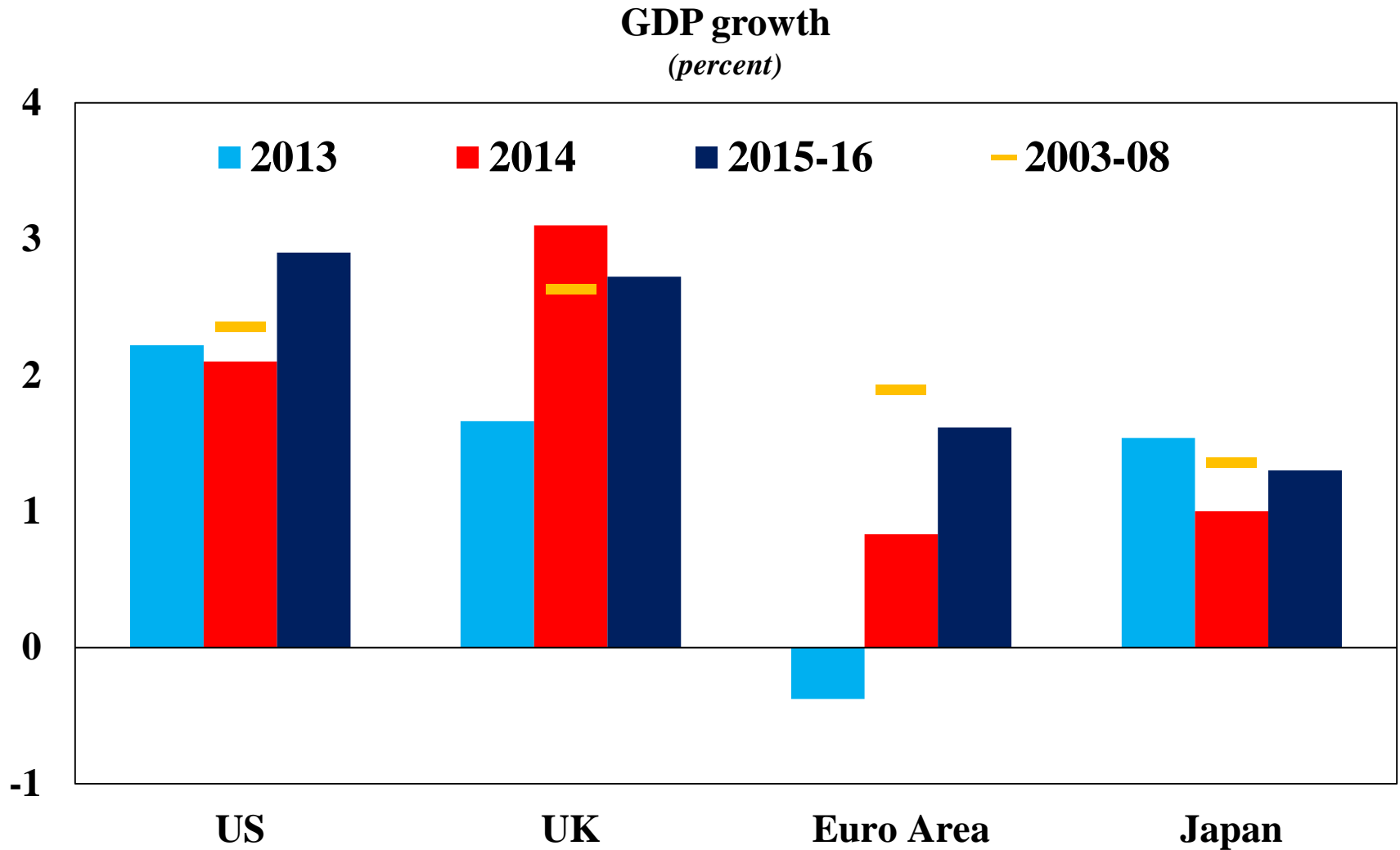
Source: Consensus Economics.

Note: Consensus Economics forecasts are aggregated based on constant 2010 USD GDP weights for G20 countries.

2. What is the outlook for high-income countries and the Euro Area?

***Diverging growth trends. In the Euro Area, weak growth, low inflation, and high unemployment***

# High-Income Countries: Diverging Growth Dynamics

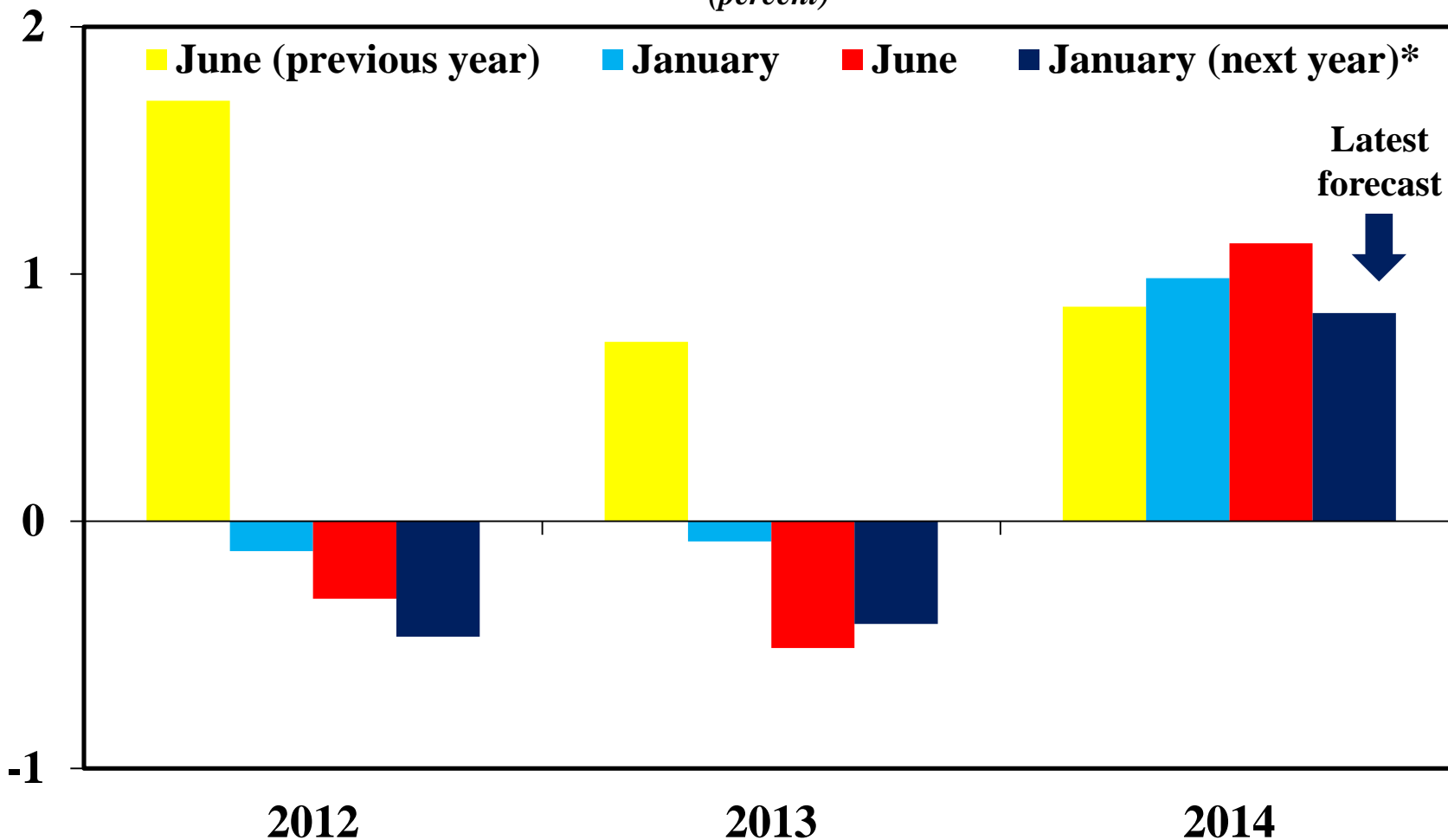


Source: World Bank.

Note: Preliminary forecasts (September 30) reflecting working assumptions

# Euro Area: Forecasts Converging to Low Growth

Euro Area GDP Growth Forecasts  
(percent)

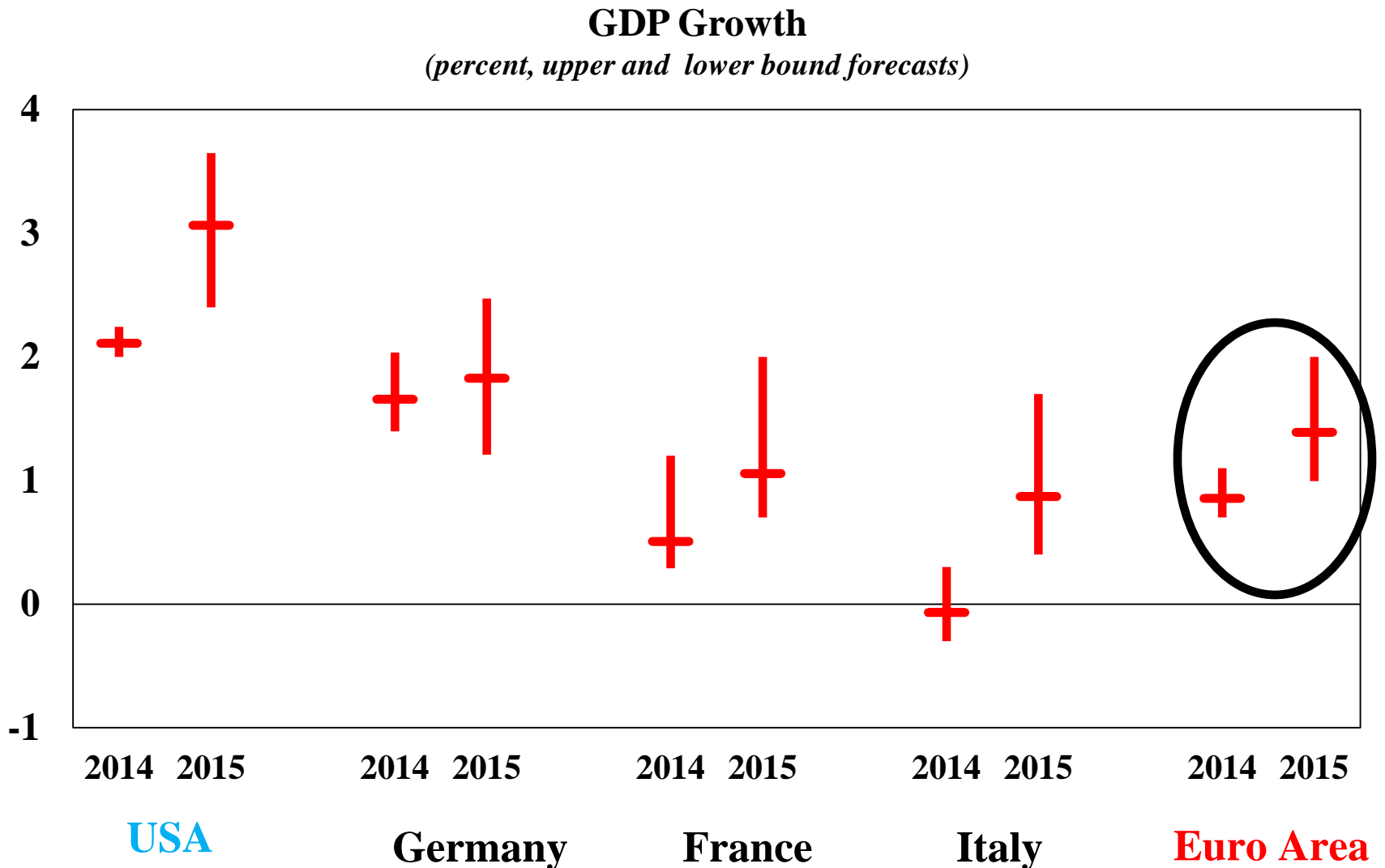


Source: Consensus Economics.

Note: Consensus Economics forecasts for the Euro area 18 (fixed composition) based on GDP volume at market price, chain linked, Euro



# Growth - Euro Area: Weak



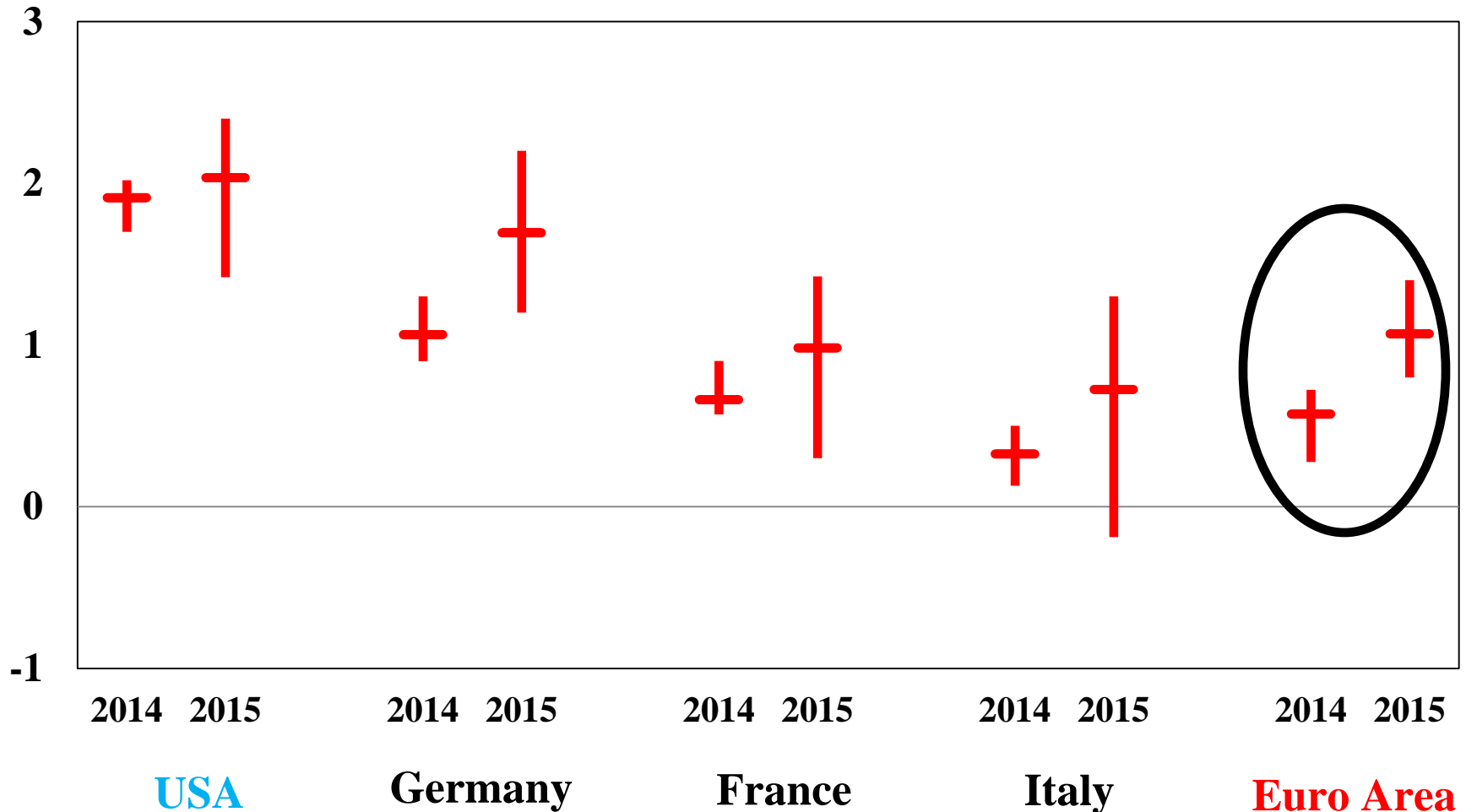
Source: Consensus Economics.

Note: Vertical line indicates the upper and lower range of Consensus forecasts; Horizontal line indicates the Consensus mean.

# Inflation – Euro Area: Low

## Inflation

*(percent, upper and lower bound forecasts, mean)*

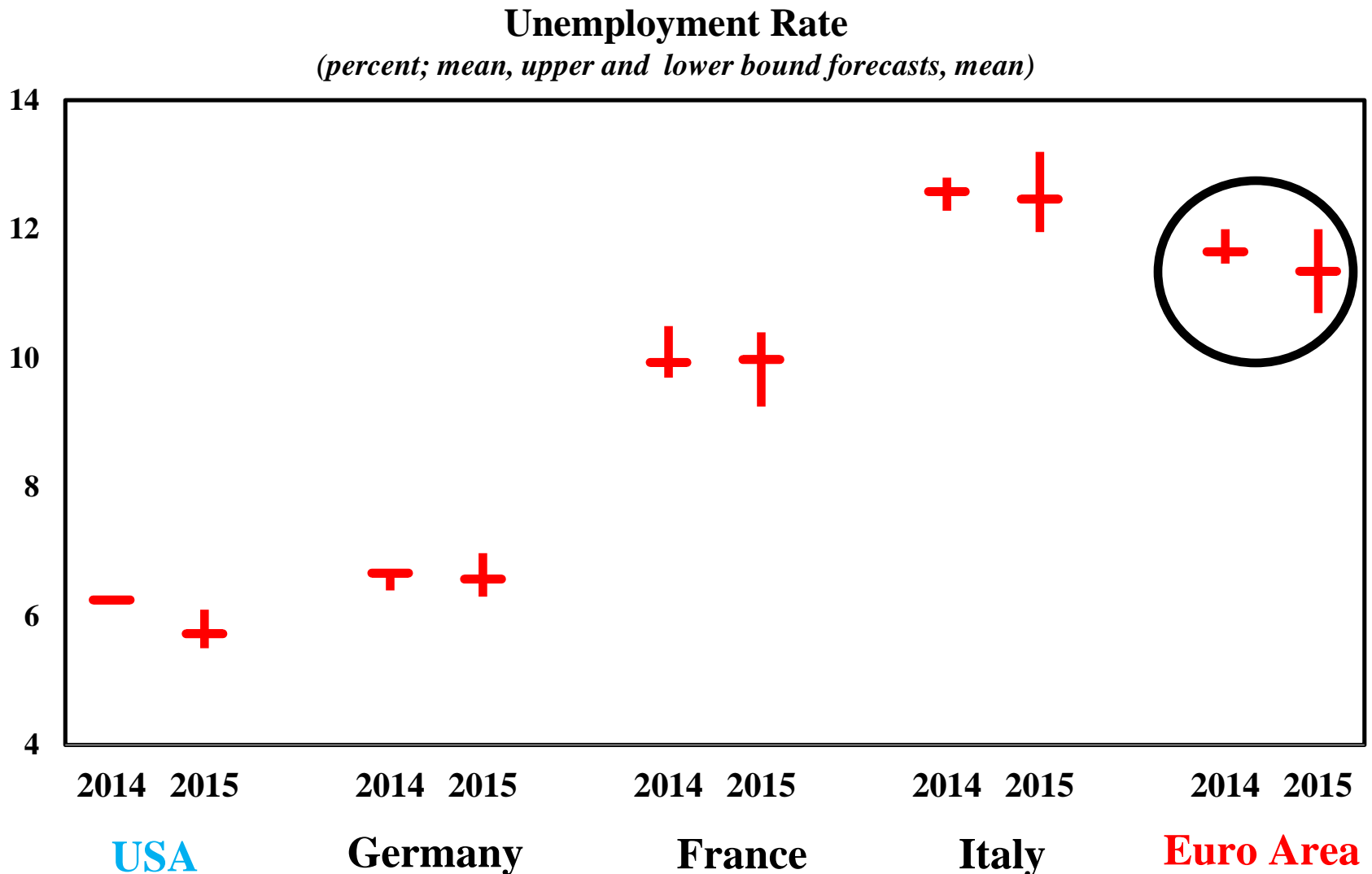


Source: Consensus Economics.

Note: Based on Harmonized Consumer Price Index for Euro Area countries, All Items Consumer Price Index for USA

Vertical line indicates the upper and lower range of Consensus forecasts; Horizontal line indicates the Consensus mean.

# Unemployment – Euro Area: High



Source: Consensus Economics.

Note: Unemployed persons as a percentage of the labor force, harmonized ILO definition

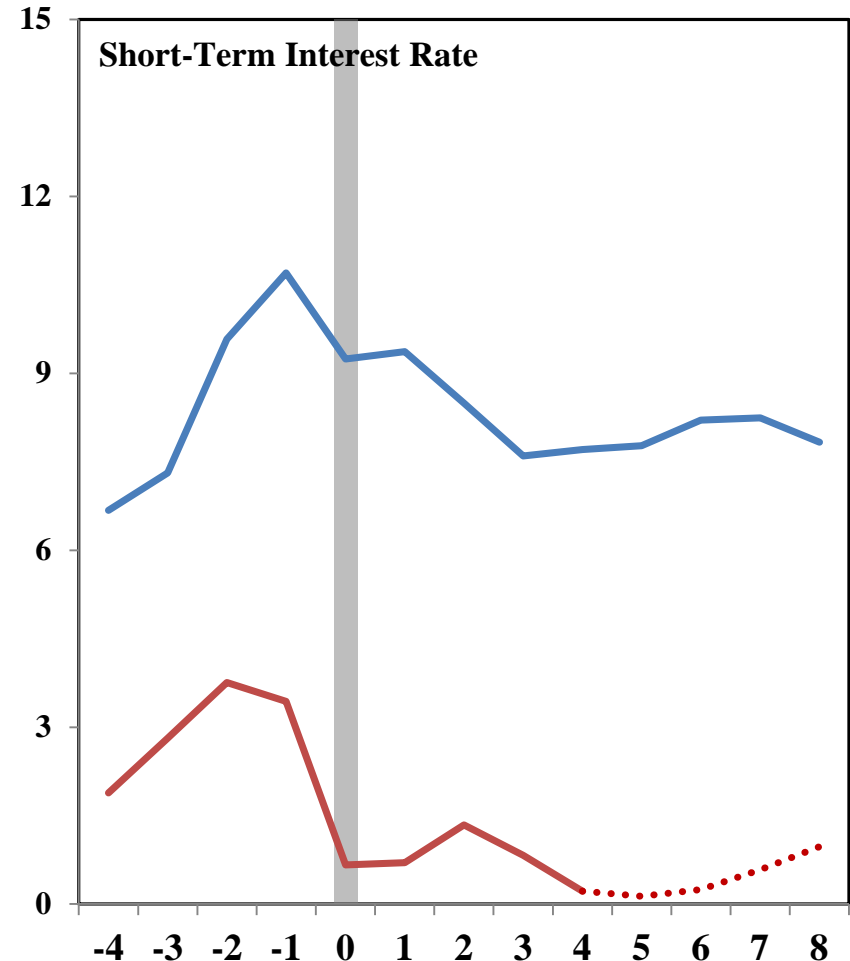
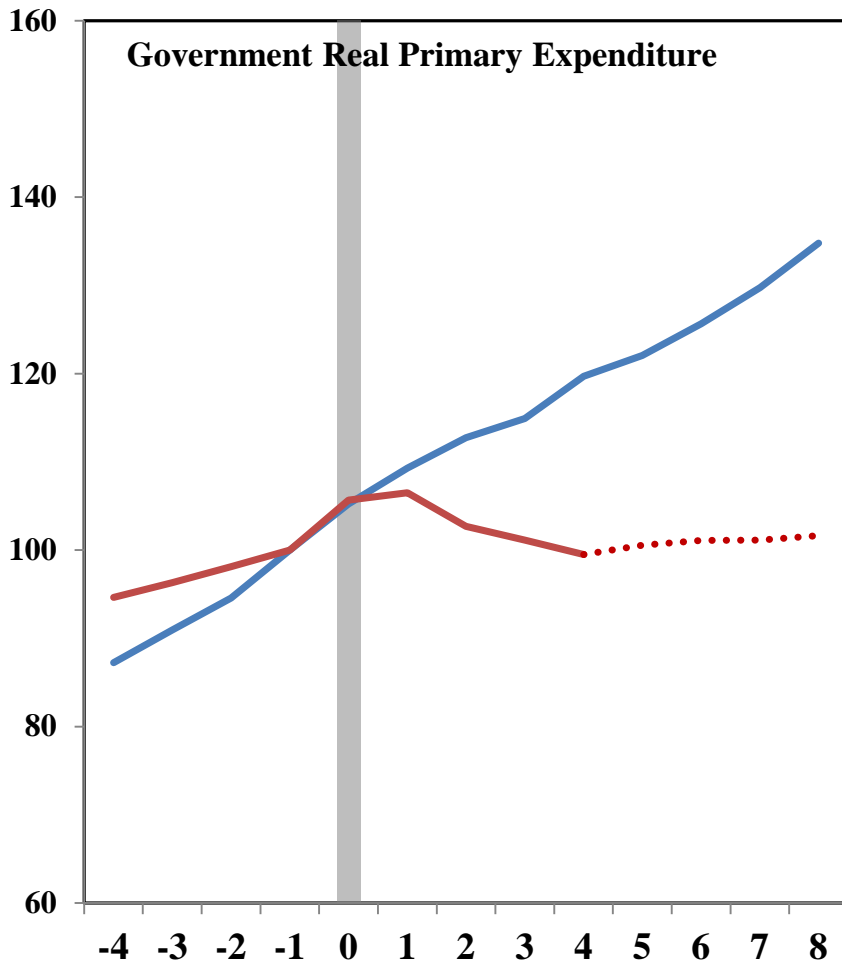
Vertical line indicates the upper and lower range of Consensus forecasts; Horizontal line indicates the Consensus mean.

3. How have Euro Area policies evolved recently compared to previous global recoveries?

***Fiscal and monetary policies were aligned in previous episodes, but have diverged recently***

# Great Divergence of Fiscal and Monetary Policies

— Average of previous recessions (1975, 1982, 1991)     — Recovery from Great Recession  
*(0=global recession year; Government Expenditures, index=100 prior to global recessions year)*



Source: WB staff calculations.

Notes: Dotted lines are forecasts/market expectations.

## 4. What lessons can the Euro Area draw from other crises?

***Focus on growth through structural reforms; maintain flexible and credible fiscal policies; and recognize debt problems***

# Lesson # 1. Implement Structural Reforms

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## 1. Focus on growth through structural reforms

- Reforms and quick rebound in growth following 1997-98 crisis allowed Asian countries (Thailand, Malaysia, Indonesia) to improve fiscal positions and reduce external debt ratios
- In Japan, low-productivity public expenditure without substantive measures to address structural problems failed to stimulate growth

*“Many of the euro area countries also face some of the same structural impediments to growth as in Japan”... “Without drastic changes, they [France, Italy and Spain] are likely to follow Japan’s path to long economic stagnation.”*

- Hoshi and Kashyap (2014)

# Lesson # 2. Have Fiscal Flexibility and Credibility

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## 2. Fiscal policies should be sufficiently flexible and credible to respond to changing circumstances

- *Fiscal policy during the Asian crisis quickly became expansionary-to-neutral; in contrast to Euro Area (Chari and Henry, 2014)*
- *Initially better fiscal conditions and countercyclical policies in Latin America during 2000s reduced duration and intensity of crises compared to earlier decades... “... procyclical fiscal policy in some Eurozone countries seems to have contributed to making the current crisis longer and more severe.” (Vegh and Vuletin 2014)*



# Lesson # 3. Recognize Debt Problems

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## 3. Quickly recognize debt problems and avoid buildup of risks

- *Austerity and spending cuts in Latin America in 1980s produced even larger debt overhang, and which made “debt restructuring inevitable” (Eichengreen, 2010)*
- *Asian countries restructured corporates and wrote down bad loans of banks during 1997-98 crisis (Cœuré 2013)*
- *In contrast, Japan’s failure to recognize and deal with bad debts related to a long period of weak growth (Hoshi and Kashyap 2014)*

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# Risks to the downside

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- Normalization / divergence of monetary policies in high-income countries
- Excessive risk-taking in financial markets
- Continued stagnation in the Euro Area
- Expansion of geopolitical tensions / health (Ebola) concerns
- Disorderly slowdown in China
- Secular stagnation in high-income and low growth in developing countries

# Fiscal Policy: Flexibility within EU rules

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- Fiscal rules needed in a single currency area
  - Essential to maintain confidence and credibility
- Stability and Growth Pact allows some flexibility
  - “Exceptional circumstances” include protracted periods of negative output gaps
  - Medium-term objective are cyclically adjusted, allowing for the interplay of automatic stabilizers (below the 3% deficit limit)
  - Consolidation plans can take reforms into account (pension, labor markets)
  - Special treatment for investment

# References

Chari, Anusha, and Peter B. Henry (2014) “Two Tales of Adjustment: East Asian Lessons for European Growth.” presented at the 2013 IMF Annual Research Conference.

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Hoshi, Takeo, and Anil K. Kashyap (2014) “Will the U.S. and Europe Avoid a Lost Decade? Lessons from Japan’s Post Crisis Experience.” presented at the 2013 IMF Annual Research Conference.

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