Economist Insights

Stretching the analogy

After a prolonged period of slowdown, growth in the economies of Europe's periphery finally appears to be catching up with growth levels in the core, as the ECB's intensive programmes of monetary (and non-monetary) support bear fruit. However, with large output gaps and high unemployment rates in many countries, one might wonder how sustainable the recovery in those economies will be. And, in particular, which countries will be more able to bring their unemployment rate down.

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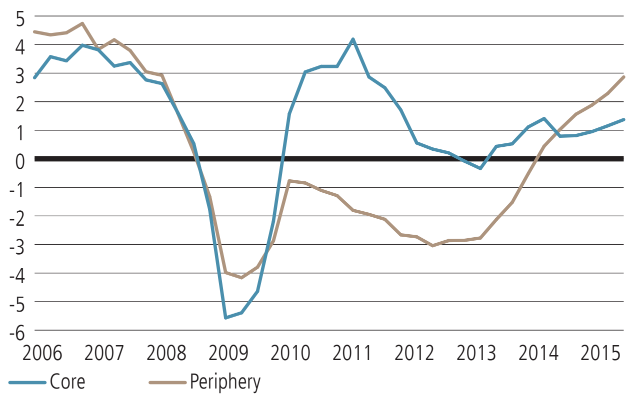
The Eurozone has spent most of the last five years running on a two speed engine: a stronger core and a slower periphery. Now both engines seem to have moved into the same gear. Not only has growth in the periphery caught up, but it is gaining momentum. The only exception is Greece, where the Syriza government managed to snatch recession from the jaws of recovery.

The periphery has faced many headwinds over recent years, and the improvement in growth has come as most of these headwinds have dissipated. The actions of the European Central Bank (ECB) are to thank for much of that improvement. The threat of direct intervention through its Outright Monetary Transactions allowed the ECB to reduce speculation about currency re-denomination risk, leading to a strong compression of sovereign spreads. Quantitative easing then helped further as actual purchases by the ECB pushed down borrowing costs even more. This gave more breathing space for the public finances and allowed a partial relaxation of austerity. At the same time, the balkanisation or fragmentation of the banking sector as each bank retreated to its home market, has receded. Progressive easing and financial sector healing has finally led to lower borrowing costs for businesses and households.

With all this monetary support, it is perhaps not surprising that the periphery has returned to positive growth. Since the periphery suffered so much more in the sovereign crisis, the gap between their actual level of output and their potential level is larger. Countries with larger output gaps tend to grow faster as they close with potential. Hence it should not be surprising that countries like Spain and Ireland are growing faster than Germany. In fact, Ireland is growing as fast as China. Overall, the periphery is now growing twice as fast as the core (chart 1).

Chart 1: Overtaking around the edge

Real GDP growth YoY in the Eurozone core and periphery



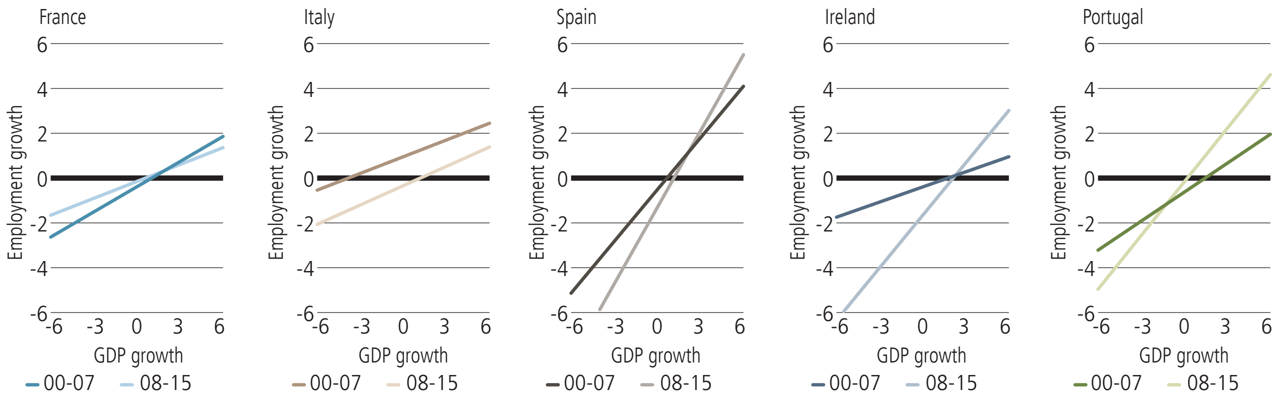
Source: Eurostat, UBS Global Asset Management. Note: Periphery is Italy, Spain, Portugal, Ireland, Greece and Cyprus. All others are core.

However, there are other factors which raise suspicions that the recovery may be driven by more cyclical factors than structural ones. The prolonged high unemployment rate in many of these countries is one particular reason to question just how self-sustaining the recovery is. If the recovery is not creating jobs, it is hard to see how sustainable consumption will be.

One way to measure the job-intensity of growth is to look at the growth elasticity of employment, or employment elasticity for short. This measures how much employment growth changes ('stretches') in response to a change in the growth rate of GDP. These elasticities can change over time, and indeed many Eurozone countries have seen big changes compared to before the crisis (chart 2). The higher the employment elasticity, the steeper the line and the more jobs that are created for each acceleration in GDP growth. The higher up the line is, the more jobs that are created from any given level of GDP growth.

Chart 2: Stretching

Relationship between employment growth and GDP growth one quarter earlier (year-on-year, %) in selected Eurozone economies, pre-crisis (2000-2007) and post crisis (2008 onwards)



Source: Eurostat, UBS Global Asset Management

France and Italy have both experienced deteriorations in their employment elasticities, but these deteriorations have been rather different. In France the slope has flattened, so it has become less elastic: fewer jobs are created with each acceleration (but fewer lost with each deterioration). In short, in France it looks like the labour market has become slightly more rigid.

In Italy the slope has not changed, but the whole curve has shifted down - so Italy creates fewer jobs for any given level of growth. Even if Italy manages to achieve the same growth rates that it did before the crisis, it looks like it will be creating less jobs. Since joining the Euro many of the jobs created in Italy have been concentrated in lower-productivity sectors than before, so the average growth rate associated with any level of employment is lower. The rigidity of the labour market likely also played a role.

In contrast, Spain, Portugal and Ireland have all become more 'employment-elastic'. As their GDP growth accelerated they generated faster job growth than before. One thing that these three countries have in common is that they all ended up in a European adjustment programme after they took financial assistance from the other Member States. Some of the most important conditions attached to these adjustment programmes were, in fact, labour market reforms. The European Commission might take some comfort from the change in elasticity – their structural reforms may be having an effect. And they will likely continue to bear fruit in the long run.

It may be possible that the (limited) job market reforms under way in France and, more recently, in Italy might have not yet started to show tangible benefits. But seeing how those reforms have benefited the rest of the periphery should be an incentive for these countries to do more. Otherwise, while the old analogy of a strong-engine core and weak-engine periphery is now looking a bit stretched, a new analogy of broken-down engines in France and Italy might end up more fitting.