Thinking ahead for Europe

DECOUPLING: CAN EUROPE AVOID A RECESSION?

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A recession in the US now appears imminent. Will Europe follow or can it 'decouple'? So far the subprime crisis has affected European financial markets at least as much as those in the US, although there is general agreement that there has been very little subprime lending in Europe. It might thus be useful to take a look at how the eurozone business cycle has related to that of the US over the last ten years.

The academic community seems to think that the eurozone does not necessarily follow the US. Following the example of the US where the National Bureau of Economic Research (NBER) officially dates the business cycle, the leading Business Cycle Dating Committee was established some time ago for the eurozone by the Centre for Economic Policy Research (CEPR). Its central finding (published in September 2003) was that "there is no clear pattern of lead-lag relation between the US and the euro area".

There are two reasons behind this finding:

1) The US experienced (a short-lived) recession in 2001, but not the euro area. In the US, GDP declined for three consecutive quarters after the peak of the final quarter of 2000, with a cumulative decline in that period of -0.62%, whereas the cumulative change of the euro area's GDP from the 1st to the 4th quarter of 2001 was still positive, even if only marginally so (+0.1%). This does not imply, however, that the eurozone fared better than the US in terms of growth since the US rebounded quickly after the recession, while growth continued to remain sluggish in the euro area for much longer. The US slowdown was thus short and sharp (conforming to the technical definition of a recession), whereas in Europe it was shallow and longer. Figure 1 shows also that in terms of GDP growth, the euro area followed the US rather closely from a common peak in 2000 to a trough in 2001 (the annual growth rate never became negative for the US because of the quick rebound following the technical recession of 2001).

2) A more important reason why at least formally one cannot establish a close correlation of business cycles concerns the evolution of employment. In 2001 employment continued to grow in the euro area (up about 1%),, whereas it fell sharply (by about 2.5%) in the US. This pattern seems to continue in the most recent data (see Figure 2), with employment growth holding up in the euro area, but falling sharply in the US. This relatively strong performance of employment is probably the reason why there have been few calls so far in Europe for a fiscal stimulus package.

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Fig 1- Annual growth rates of real GDP (%)

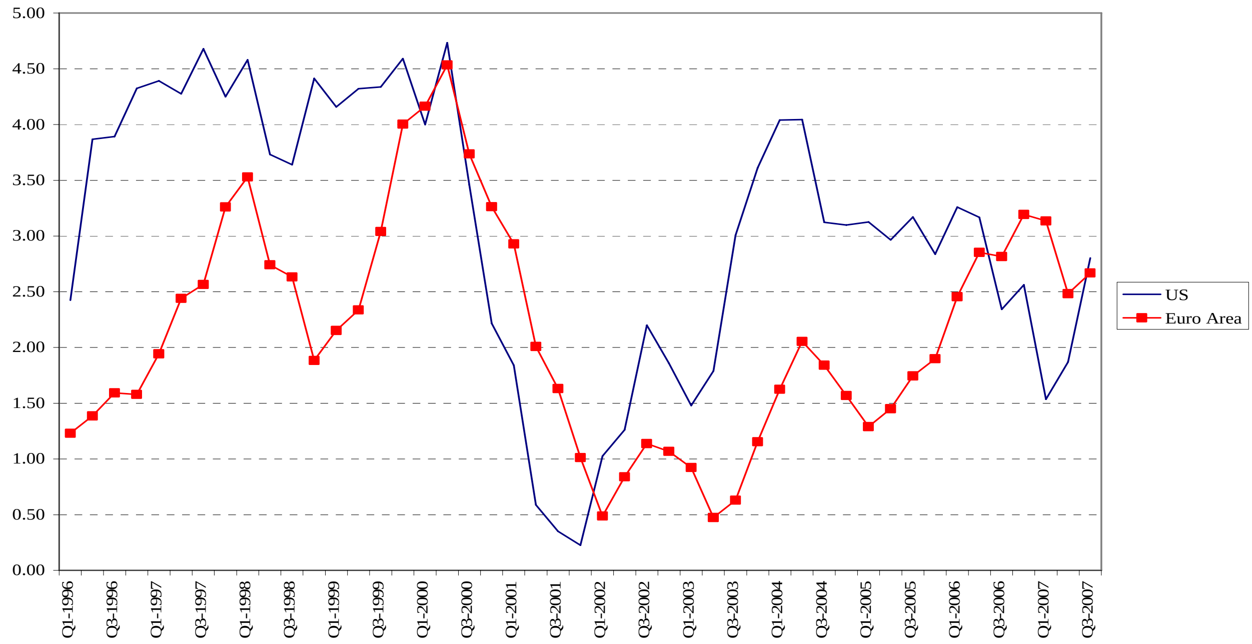
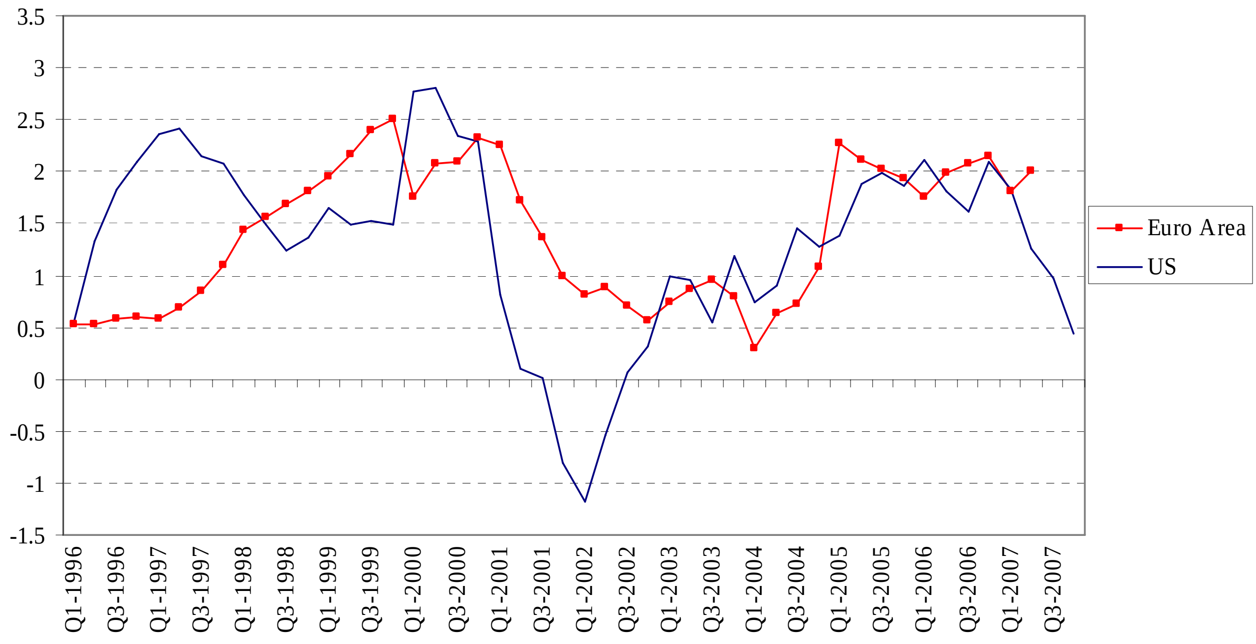


Fig. 2- Annual growth rate of Employment (%)



What does this brief examination of the past suggest for the current situation? The goods news is that the eurozone should be able to avoid a technical recession and that employment growth is likely to remain relatively robust. Having a more sluggish economy has its advantages during bad times. The bad news is that any recovery might also be much slower in starting in Europe.

One important aspect of how business cycles are experienced in real time (as opposed to how they look in retrospect) is that the data that are available in real time consist typically of first estimates which tend to exaggerate the size of the downturn. This is illustrated in Figures 3 and 4, which show that for both employment and GDP growth the first estimates suggested that the euro area was in, or very close to, a recession in 2001, but subsequent data revisions, mostly upwards, did not support this view. This pattern makes a timely policy response even more difficult to calibrate. At the very least, one should take these important data revisions as a warning against policy activism.

Fig. 3- Employment in the euro area (annual growth rate): first estimates and final data

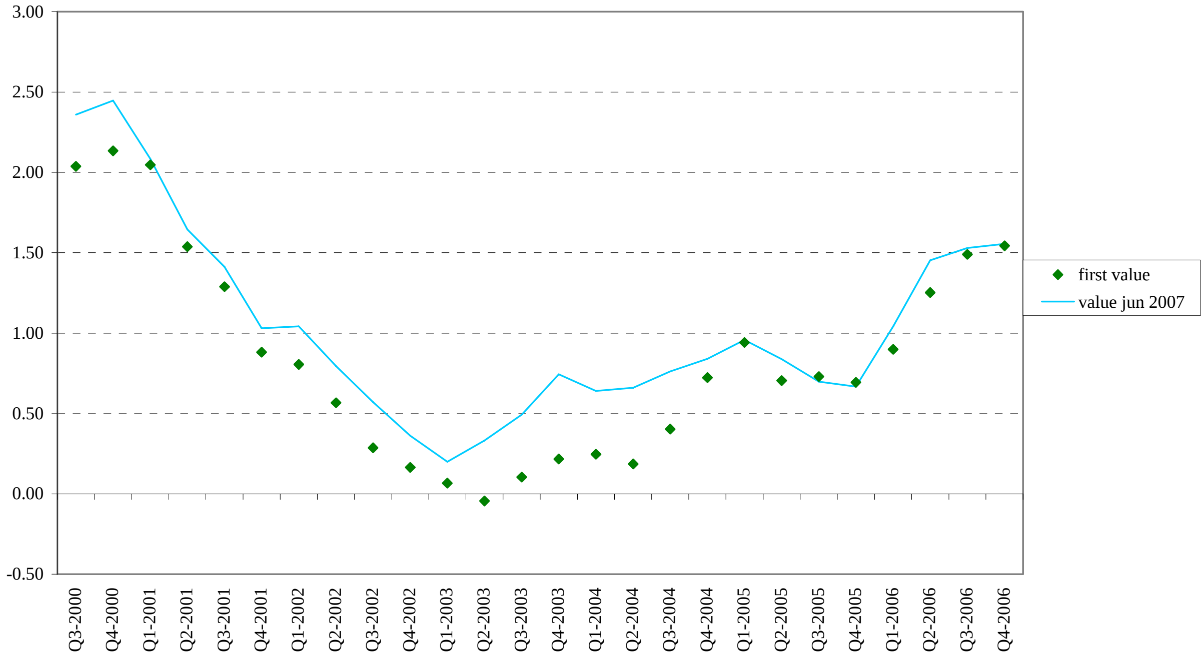


Fig. 4 - GDP growth in the Euro area (annual rates): first estimates and final values