# Roads to recovery

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# The Great Recession 2008-2013

- Financial crisis:
  - Global imbalances
  - Risk perception
  - Complex and risky financial innovations

- Euro crisis:
  - International risks and national supervision
  - Banks and sovereigns: suffocating embrace
  - Consolidation

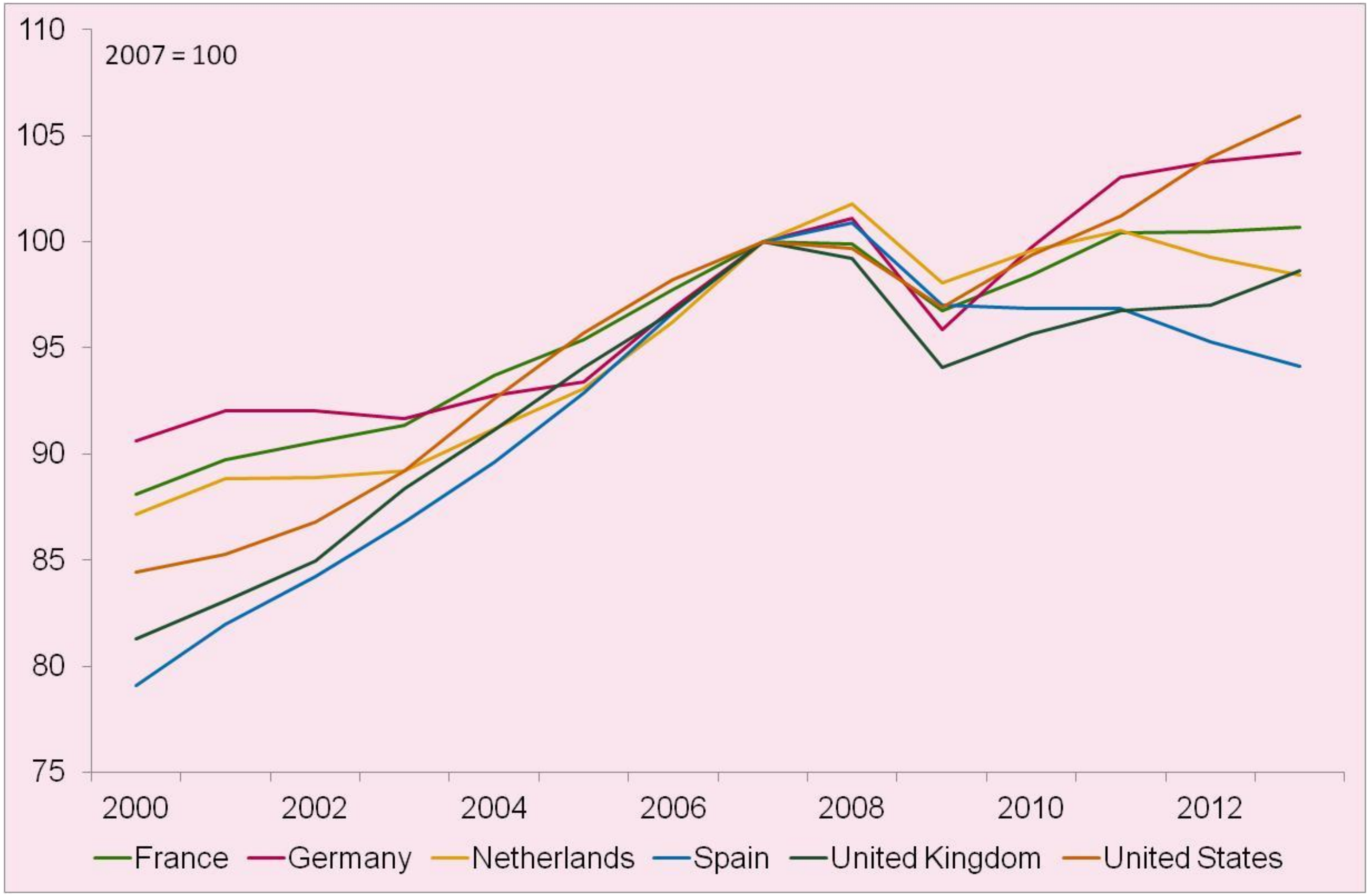
- 2014, where are we now?

- 2014-2023, what are the roads to recovery?

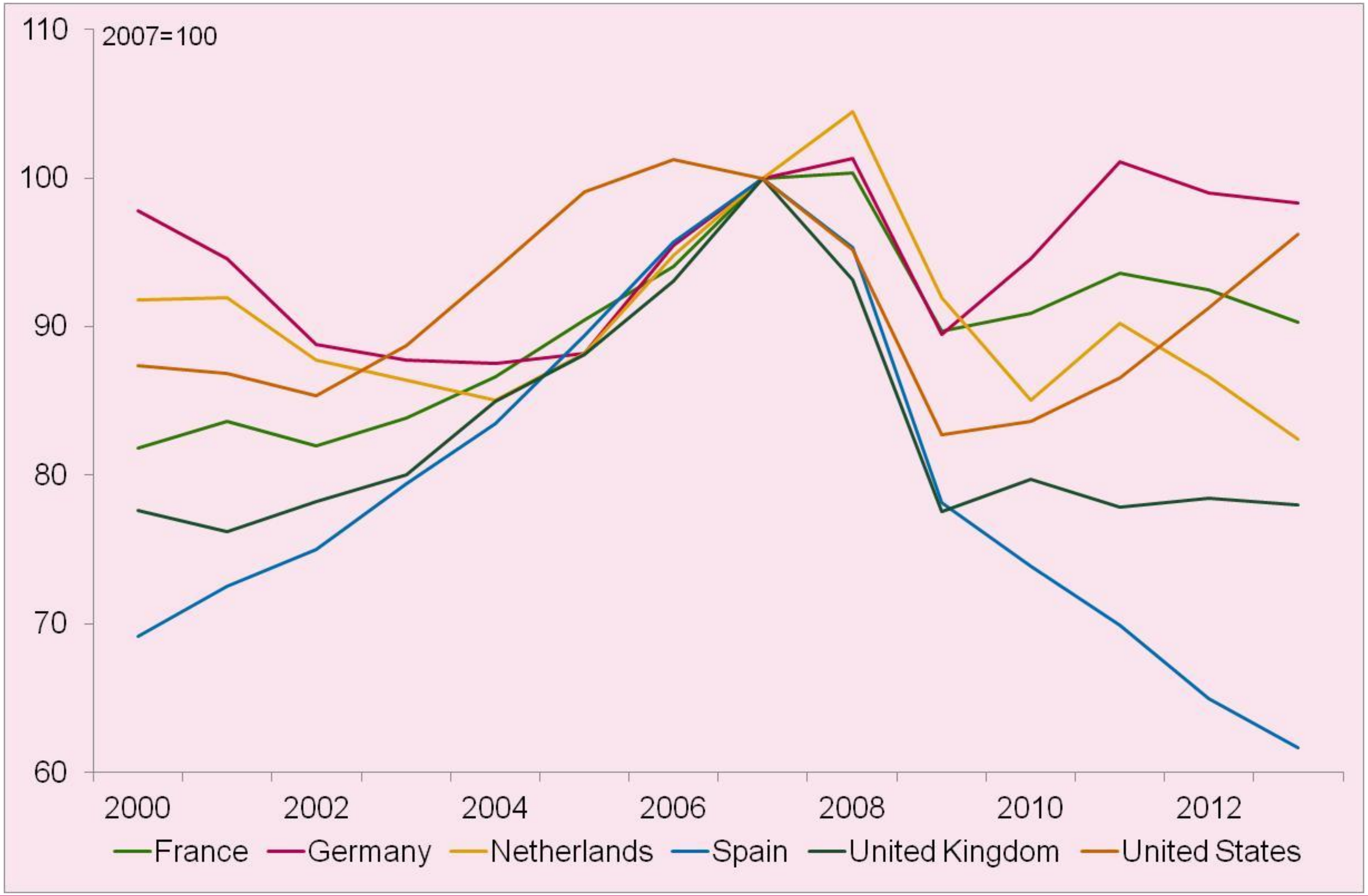
# Europe in the aftermath of the Great Recession

- A permanent loss ...
  - reduction in the level of potential GDP
- ... but a resilient economy
  - *no* reduction in the growth rate of potential GDP (in coming decade)
- Gradual recovery ...
  - closing of the output gap may take a decade
- ... with risks on the demand side
  - deleveraging & austerity, investment & credit

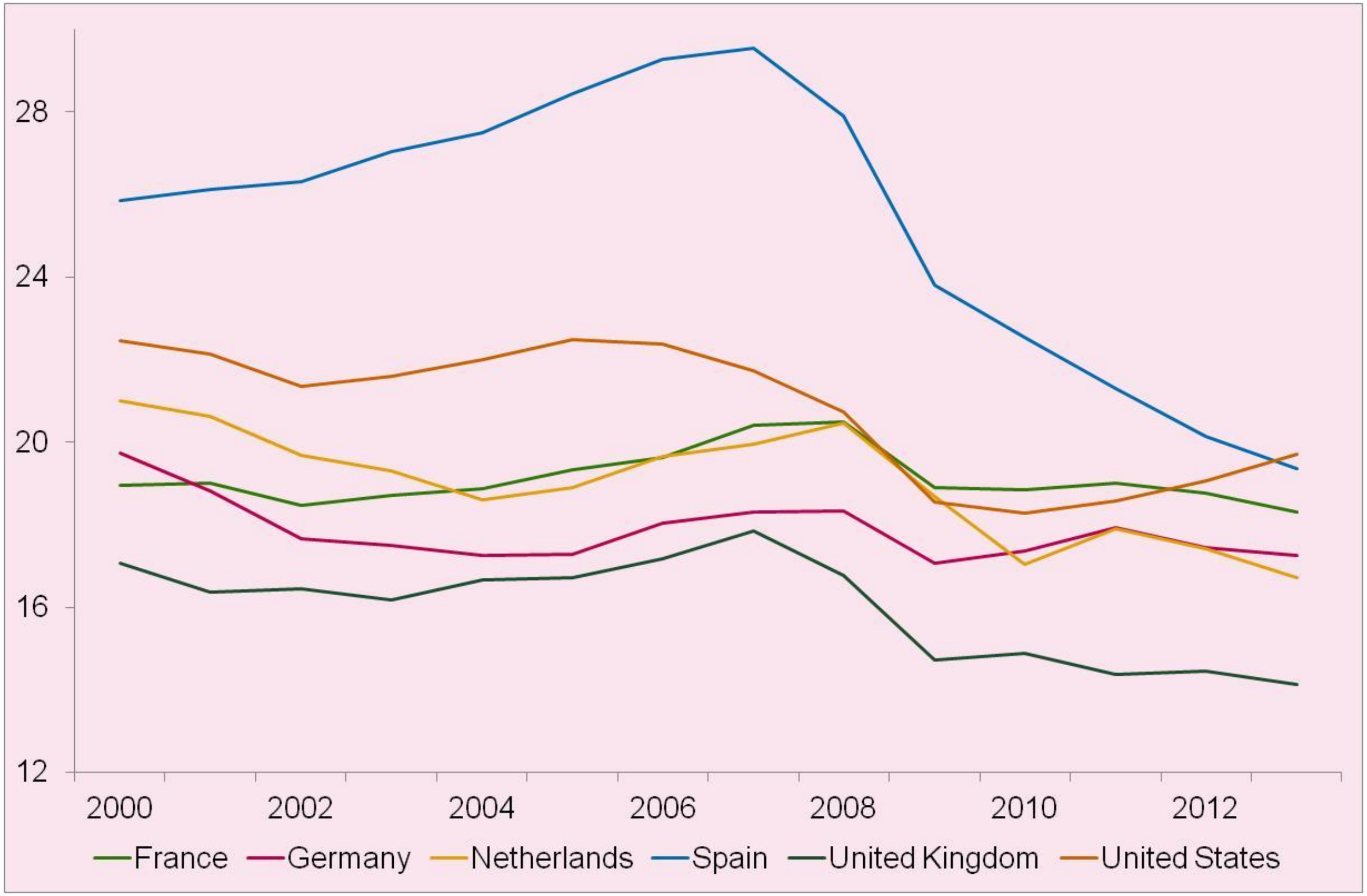
# Significant damage to GDP ...



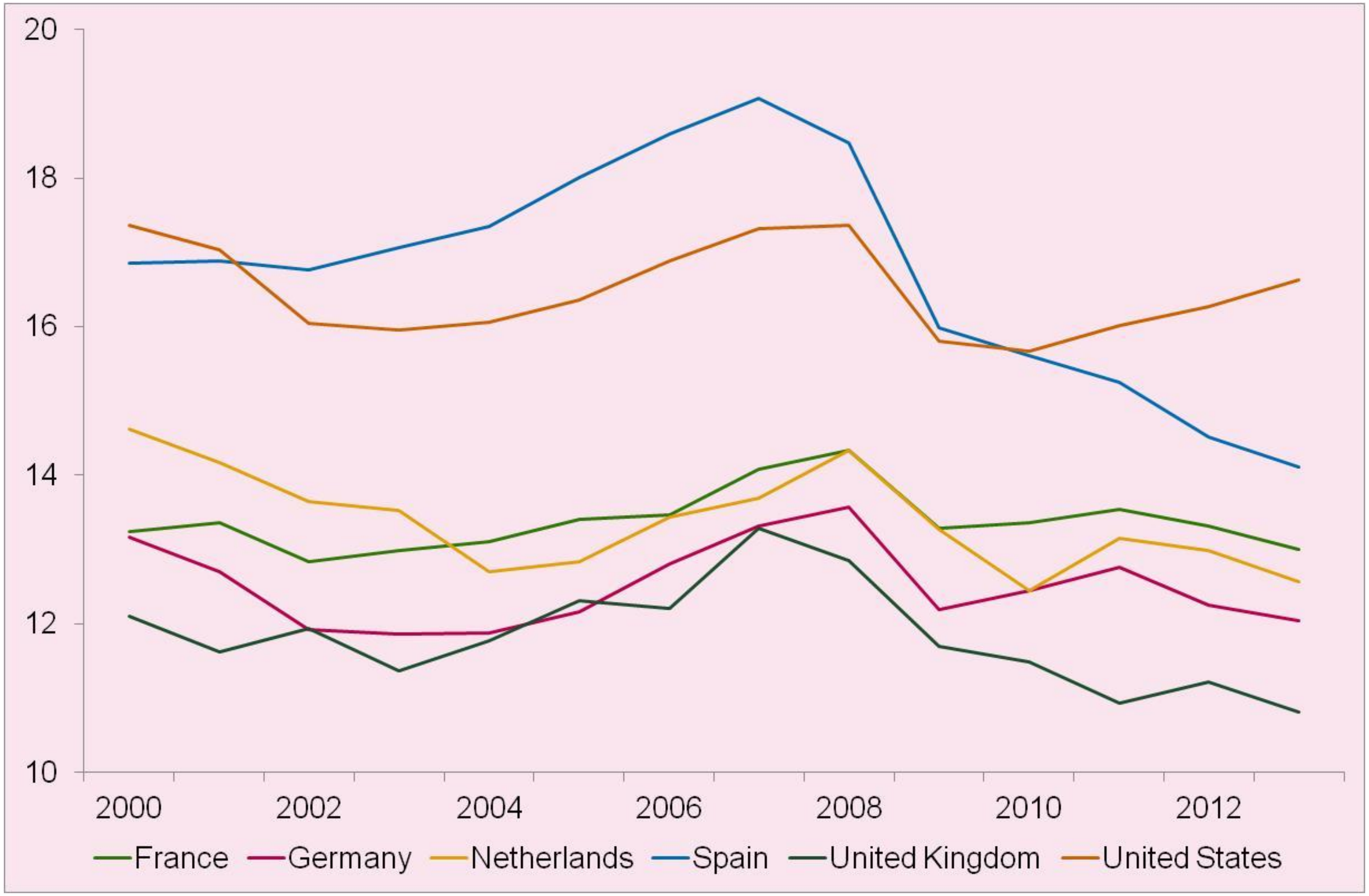
# ... and investment



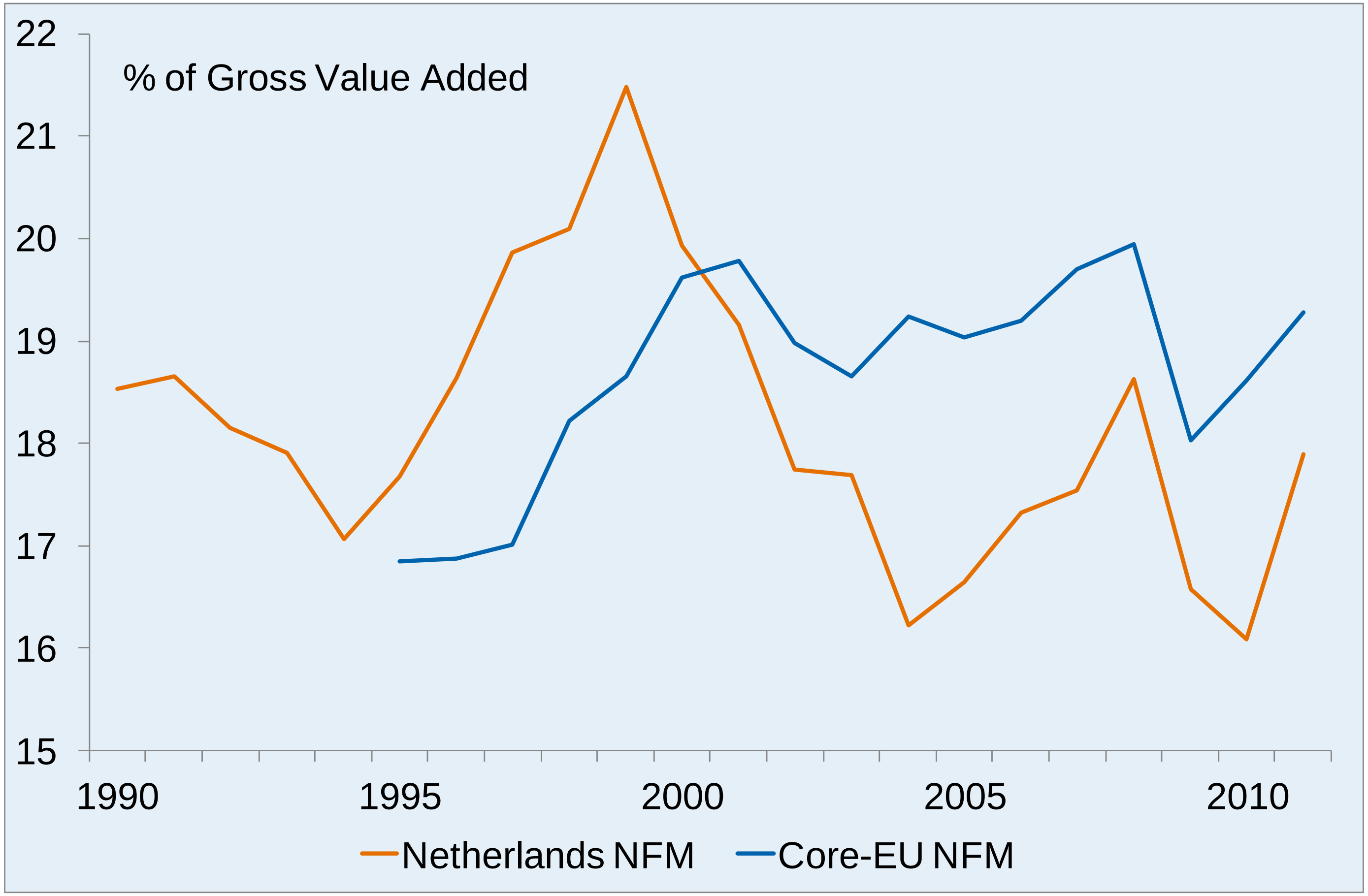
# Investment (% GDP) falls after crisis ...



# … but investment excl. dwellings fall much less



# … and even less in real terms



# Physical capital

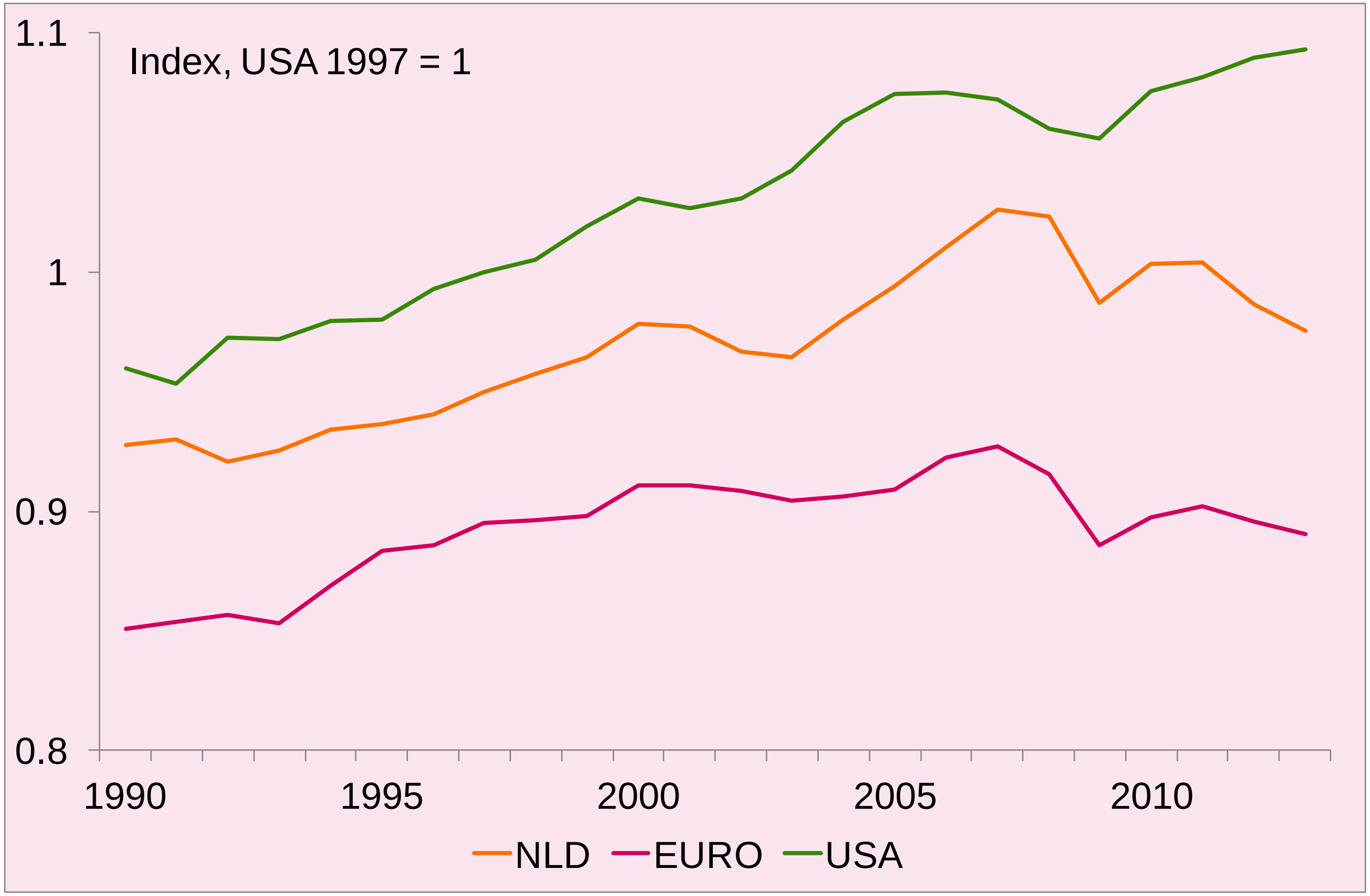
- Relatively large drop in investment largely explained by housing

- Decline in other investment not really related to the crisis
  - Investment-GDP ratio same in 2012 as 2004/5

- No obvious damage
  - Puzzle: where is credit rationing?

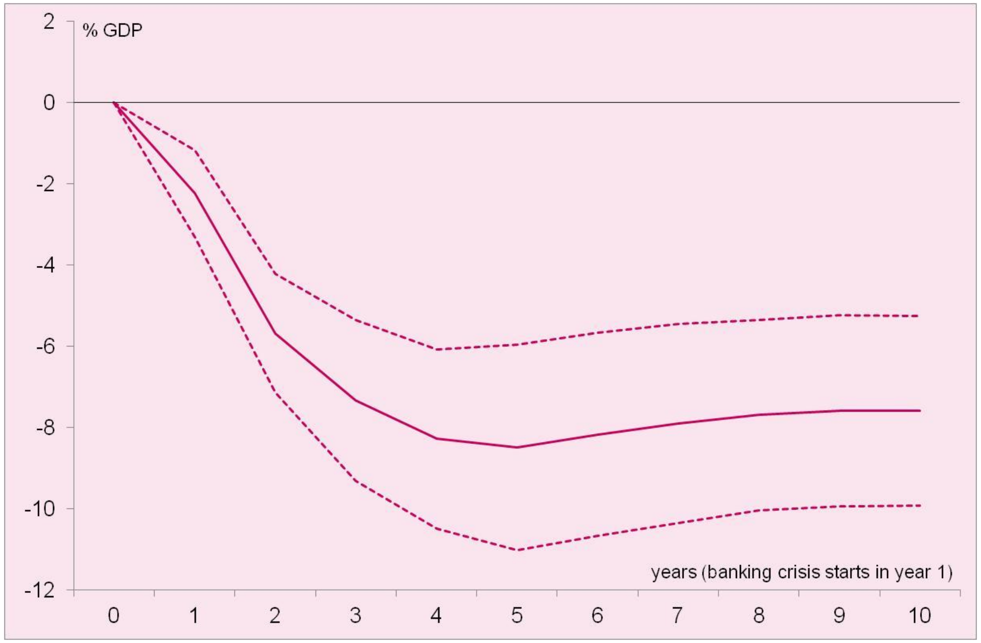
- Banks relatively weakly capitalised
  - May limit credit supply in a recovery
  - AQR and stress test may support confidence

# Labour productivity in Europe and USA



# Productivity will resume growth (after a permanent loss)

- Banking crisis are associated with large, permanent declines in productivity relative to the previous trend.
- Reproduction of Serra-Cexana in Chapter 4 of *Roads to Recovery*
- No evidence that banking crises have a long-run effect on the growth rate of productivity



# What might explain losses in productivity?

- Mechanisms
  - low price of risk before crisis -> bubble
  - change in investment

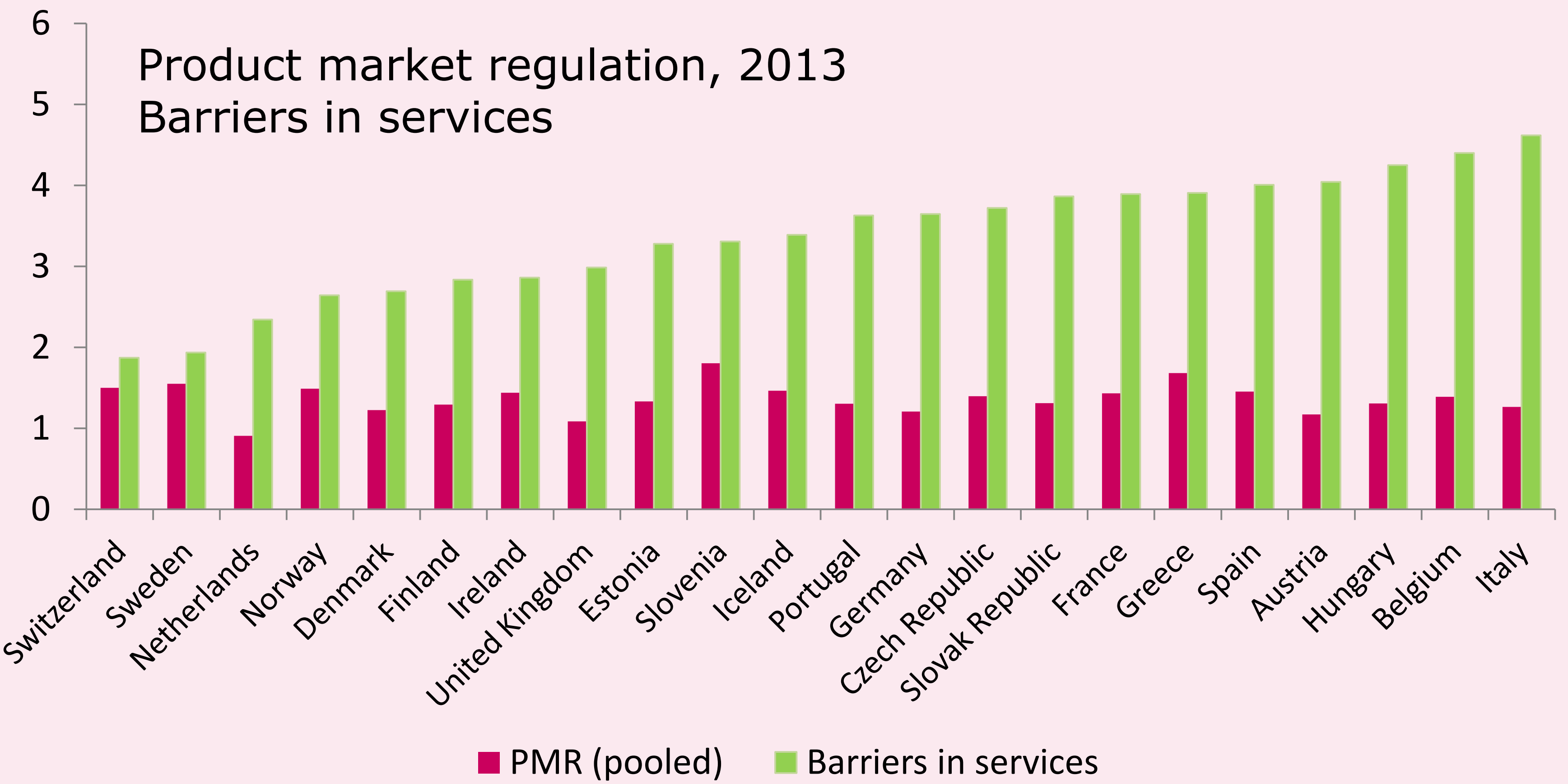
  - loss of skills during unemployment

  - less R&D (lower expectations)
  - more R&D (lower opportunity costs)

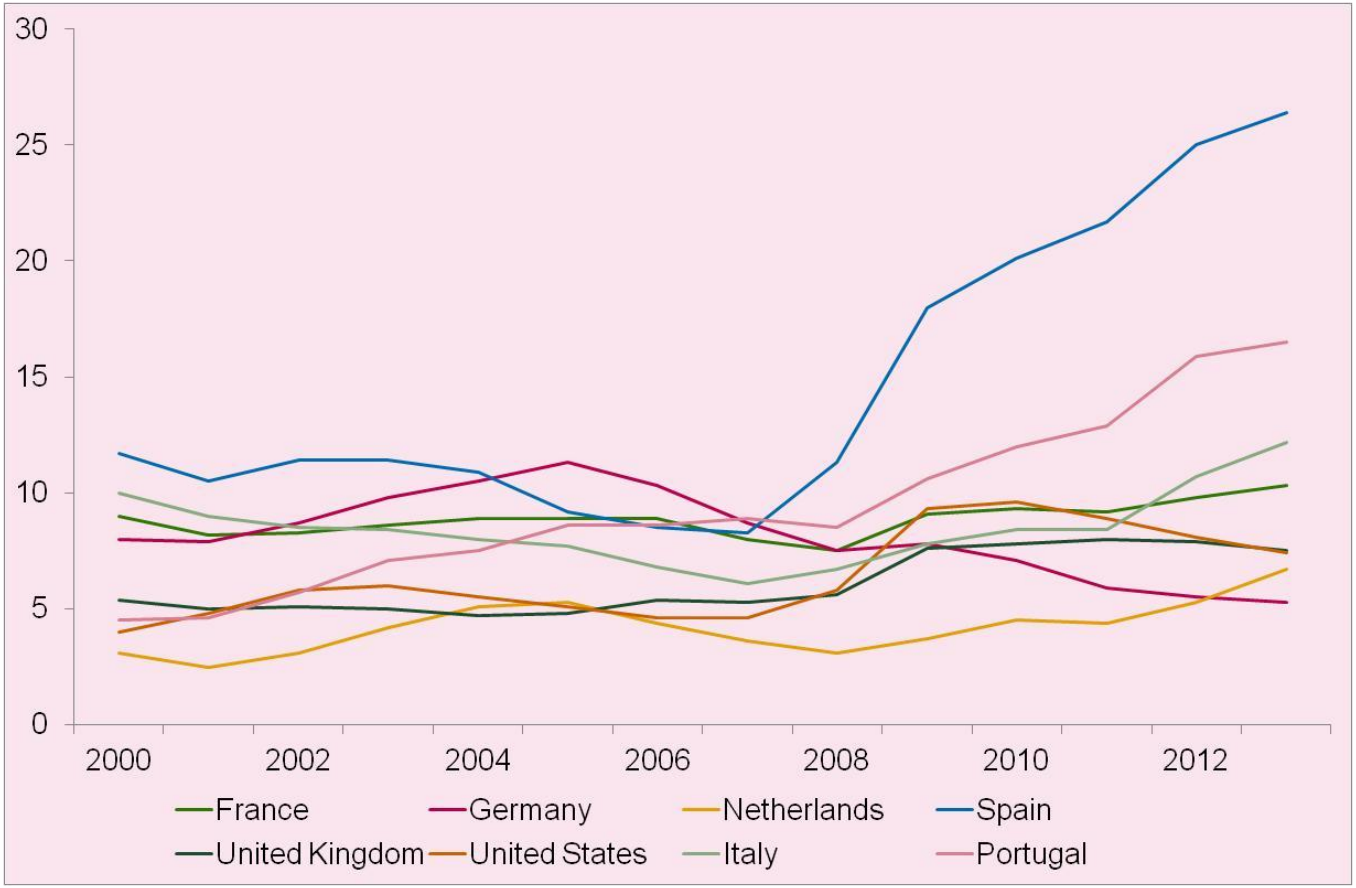
  - fiscal austerity

- Much unknown
  - Just as Great Depression, 1930s

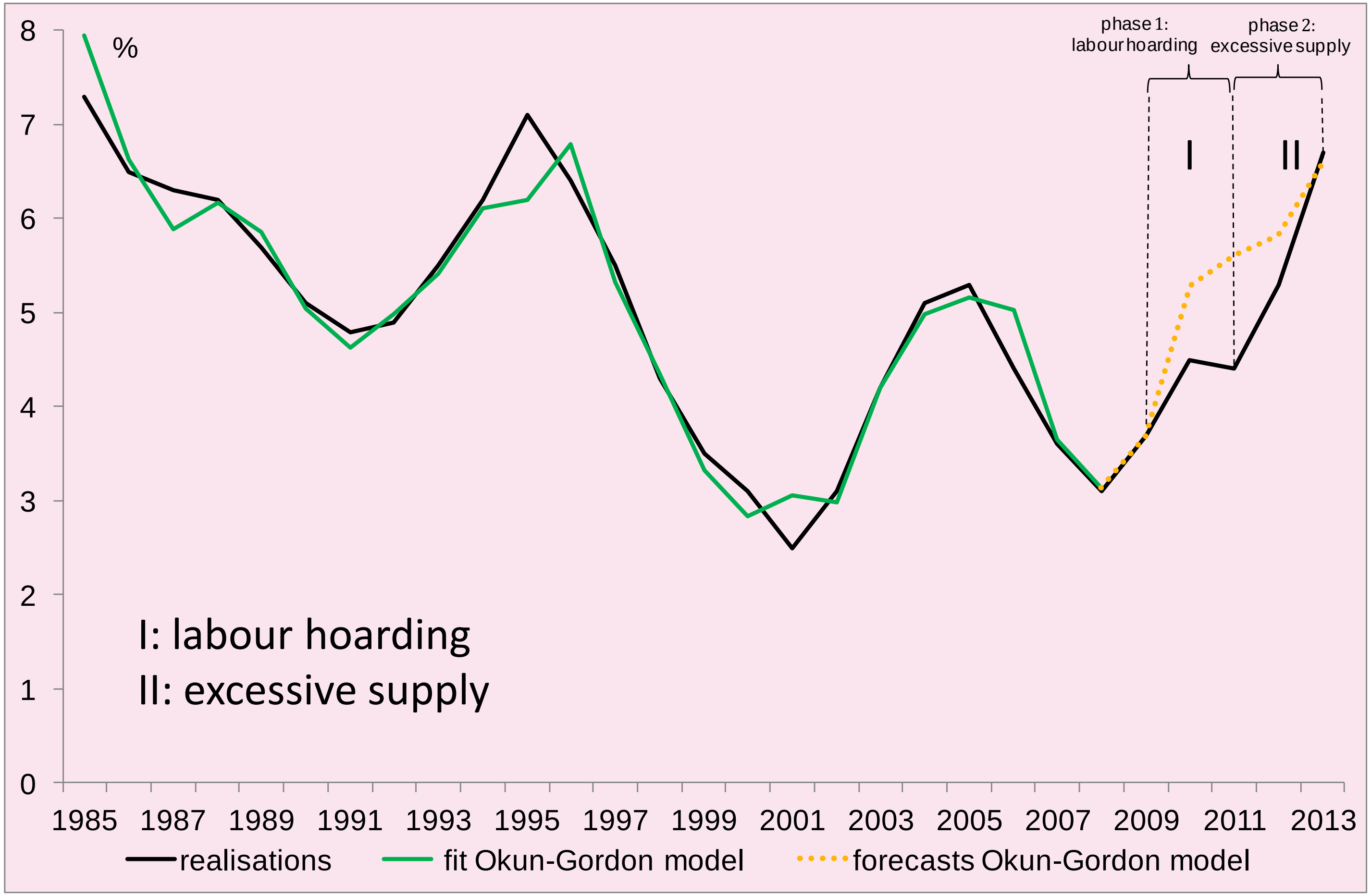
# Yet, there is room for improvement



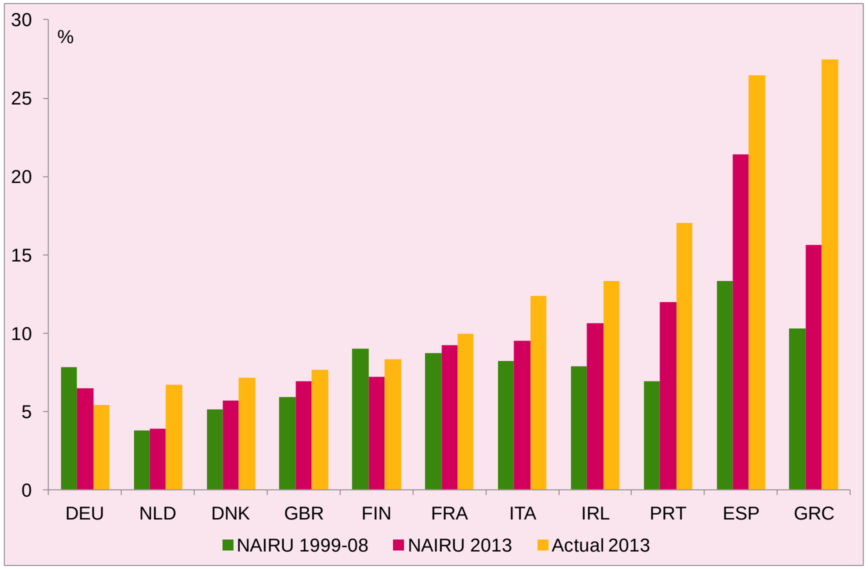
# Rising unemployment (% labour force)



# Unemployment in the Netherlands



# Unemployment, actual and NAIRU

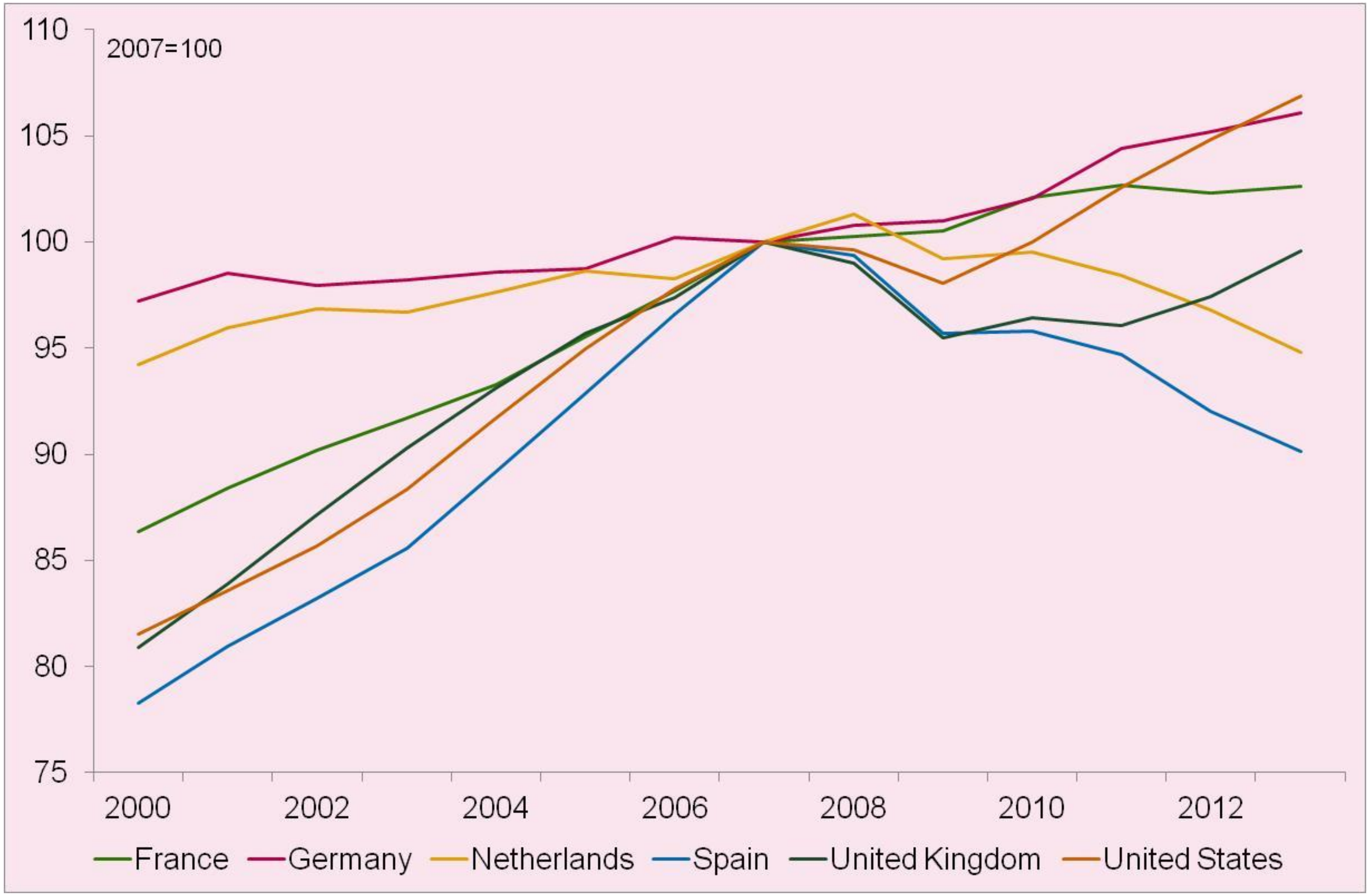



- Large heterogeneity
- Structural reform may benefit southern European countries
- Literature provides limited evidence for hysteresis ...
- ... but productivity of long-term unemployed may decline (scarring)

# Labour market will return to equilibrium

- When aggregate demand recovers,
  - employment follows suit
  - unemployment returns to the natural rate
  - discouraged workers return
- Hysteresis: no evidence
- Scarring (loss of skills): some evidence
- The Great Recession does not permanently affect labour supply, but may have affected the human capital of the long-term unemployed

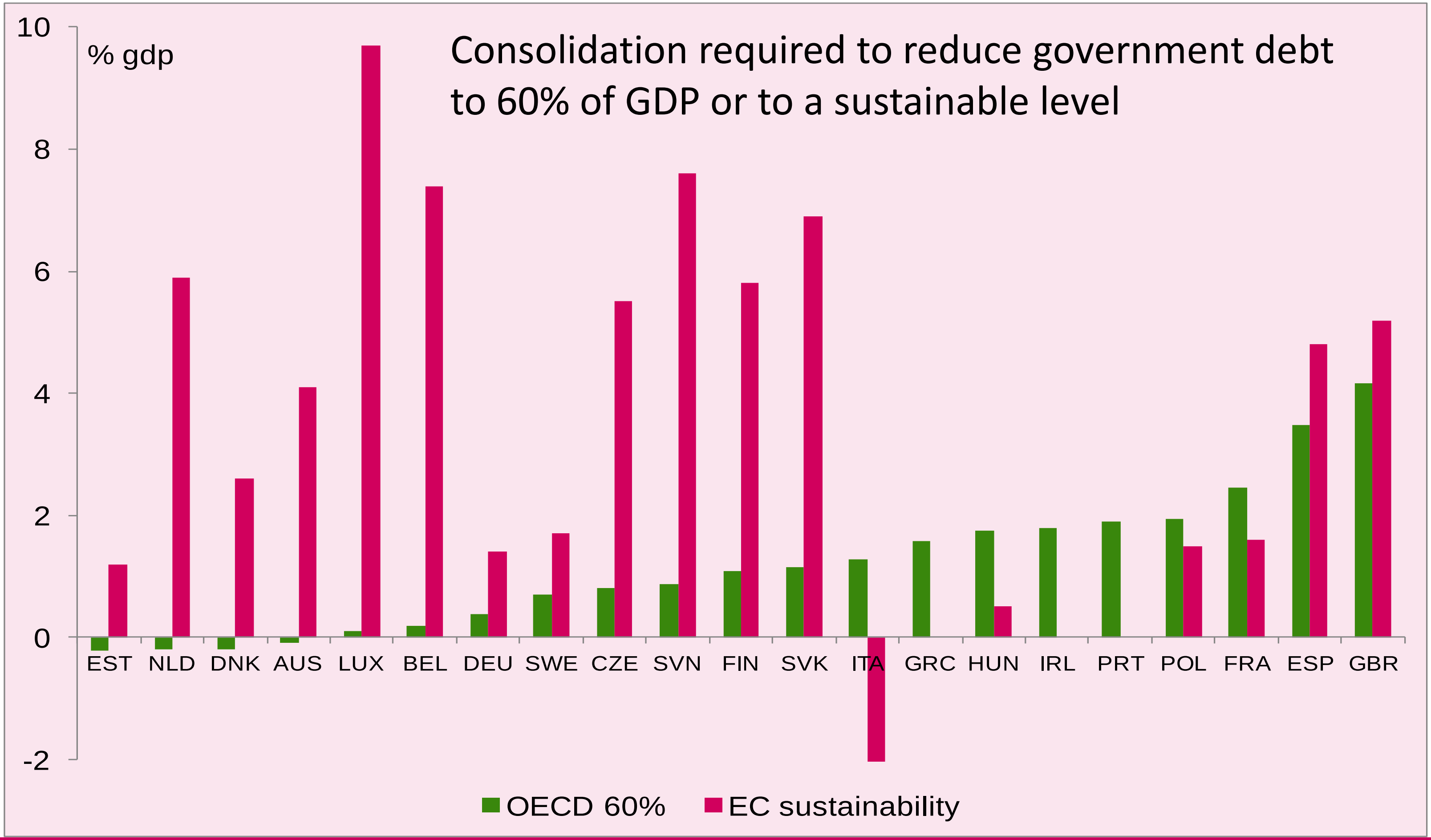
# Falling domestic demand: consumption



# Households face high debts

# Indicators pointing at deleveraging

# Austerity may harm growth

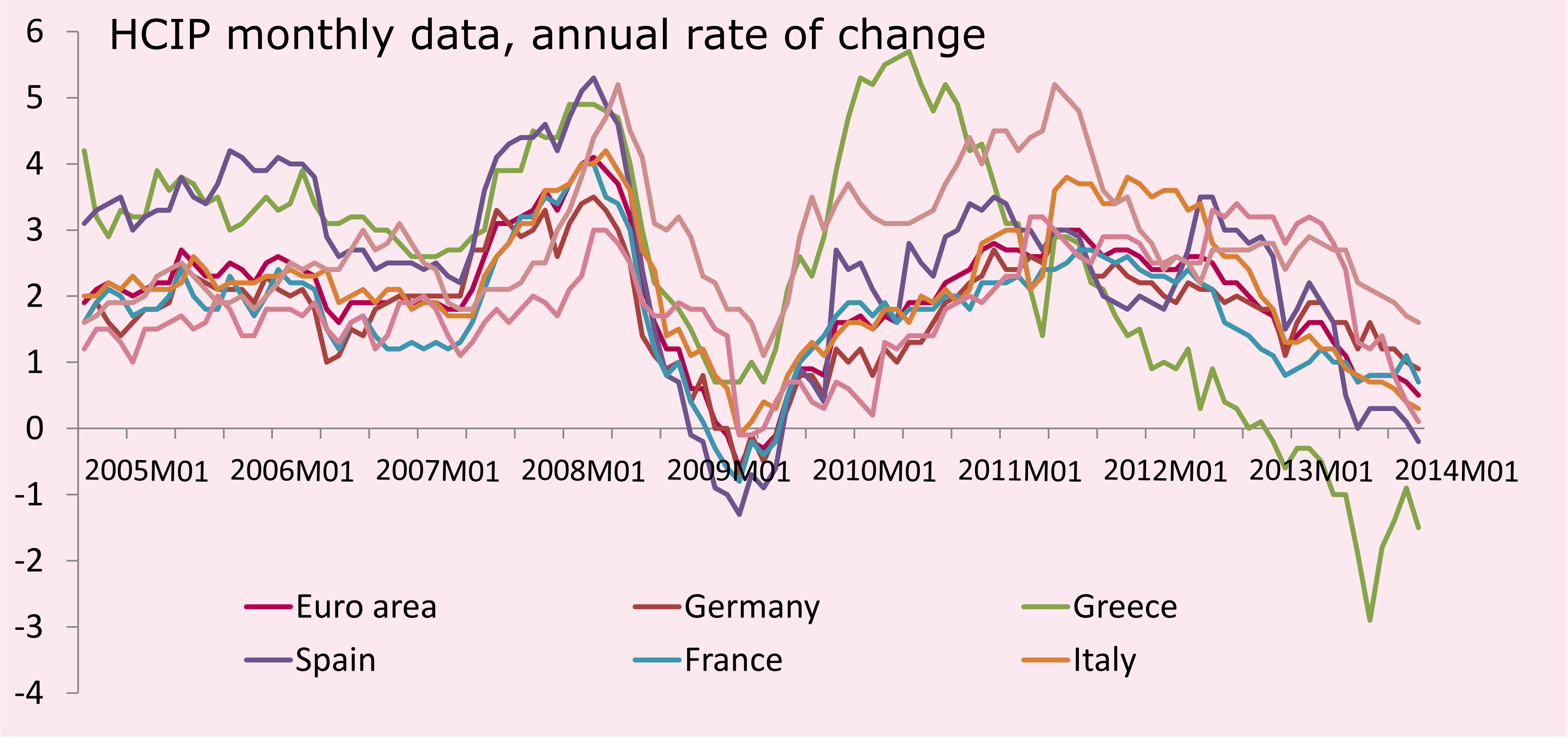


# Deleveraging <=> economic growth

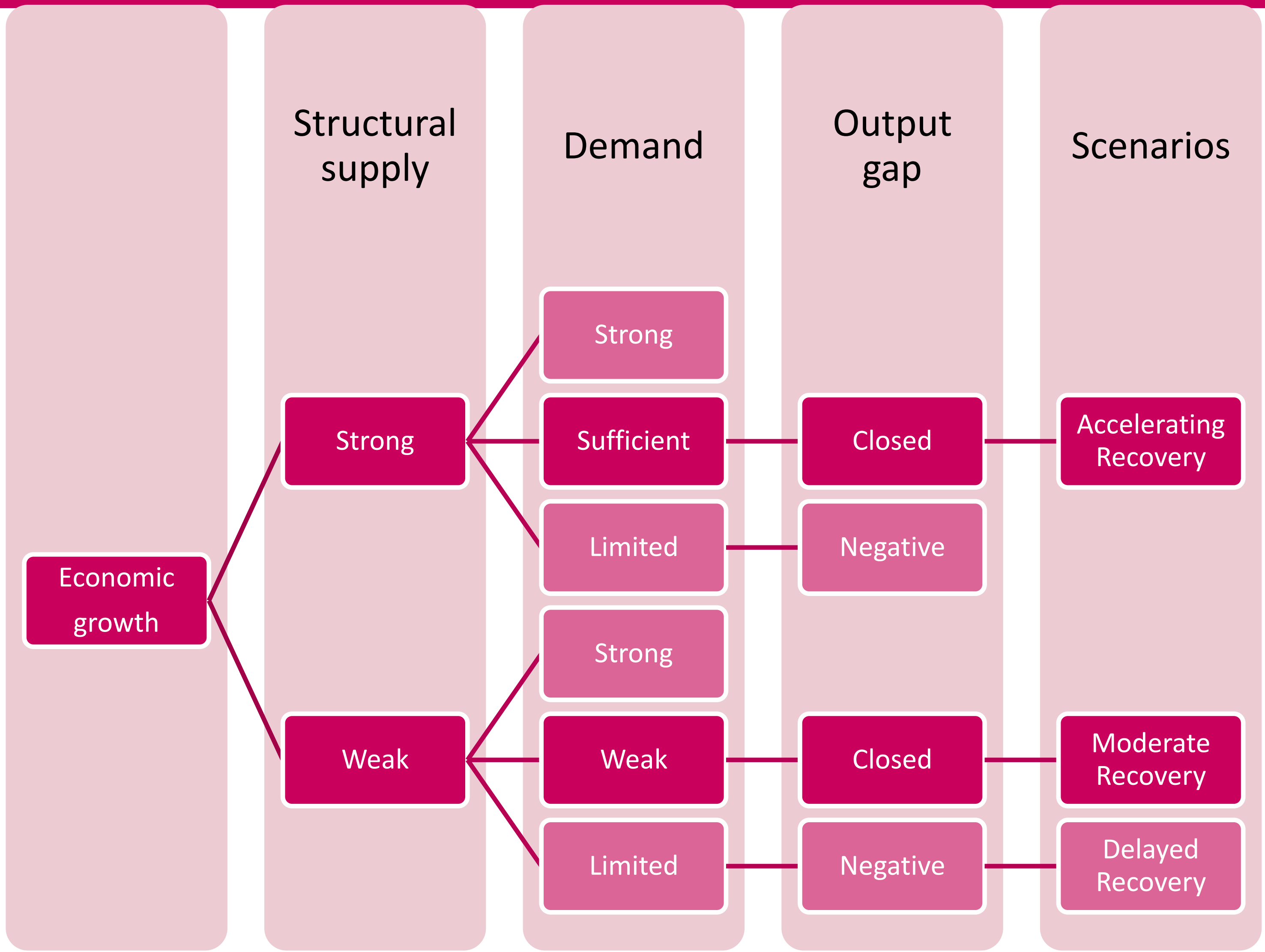
- Economic growth may limit need to deleverage
  - limited decline of households wealth
  - assets still higher than liabilities
  - nominal growth may inflate debt problem
  - doesn’t harm recovery

- But, deleveraging may harm growth
  - indicators point at deleveraging
  - households and government (and firms) may all decide to save
  - weakening demand and **nominal** growth
  - aggravating deleveraging challenge

# On the brink of deflation?



# Three roads to recovery


Structural supply
Demand
Output gap
Scenarios
Economic growth
Strong
Weak
Strong
Sufficient
Limited
Strong
Weak
Limited
Closed
Negative
Closed
Negative
Accelerating Recovery
Moderate Recovery
Delayed Recovery

# Three roads to recovery

- The economy is resilient, but the recovery of aggregate demand will take time.

- Depending on strong or weak supply, over the next decade the European economy may grow by 1½% (*Moderate Recovery*) to 2¼% (*Accelerated Recovery*) per year.

- When substantial demand risks materialise the economy will not recover in the coming decade and government debt deteriorates (*Delayed Recovery*).

# Three scenarios, 2014-2023

| | accelerating recovery | moderate recovery | delayed recovery |
|---|---|---|---|
| | | | |
| | | | |
| Gross domestic product, Euro area | 2¼ | 1½ | 1 |
| Gross domestic product, USA | 3¼ | 3 | 3 |
| World trade, weighted (for Nld) | 6¾ | 5 | 3 |
| | | | |
| Inflation, euro area (ultimo) | 2¼ | 1¾ | 1 |
| Interest rate, euro area (ultimo) | 4¾ | 4 | 2¼ |
| | | | |

# 2014, the facts

- Low GDP growth, but at least the economy grows
- Low inflation, but still positive
- High unemployment, with first signs of decline
- High government debt
- Low interest rates, low CDS-spreads
- ...

# 2014-2023, our assessment

- The economy is resilient, but demand remains fragile
  - in Europe and the Netherlands

- Resilient
  - productivity growth will resume
  - labour markets will return to equilibrium
  - recovery of the economy will weaken the deleveraging challenge

- Fragile
  - deleveraging may delay growth
  - consolidation may harm growth
  - credit supply may limit investment and consumption

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- Stellingen ??

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