

**FISCAL ADJUSTMENT AND GROWTH**

**OR**

**EXTERNAL ADJUSTMENT AND GROWTH**

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# External Adjustment and Growth



**Short term** cost of fiscal adjustment (=reduction in deficit) classic problem. What is specific about euro area?

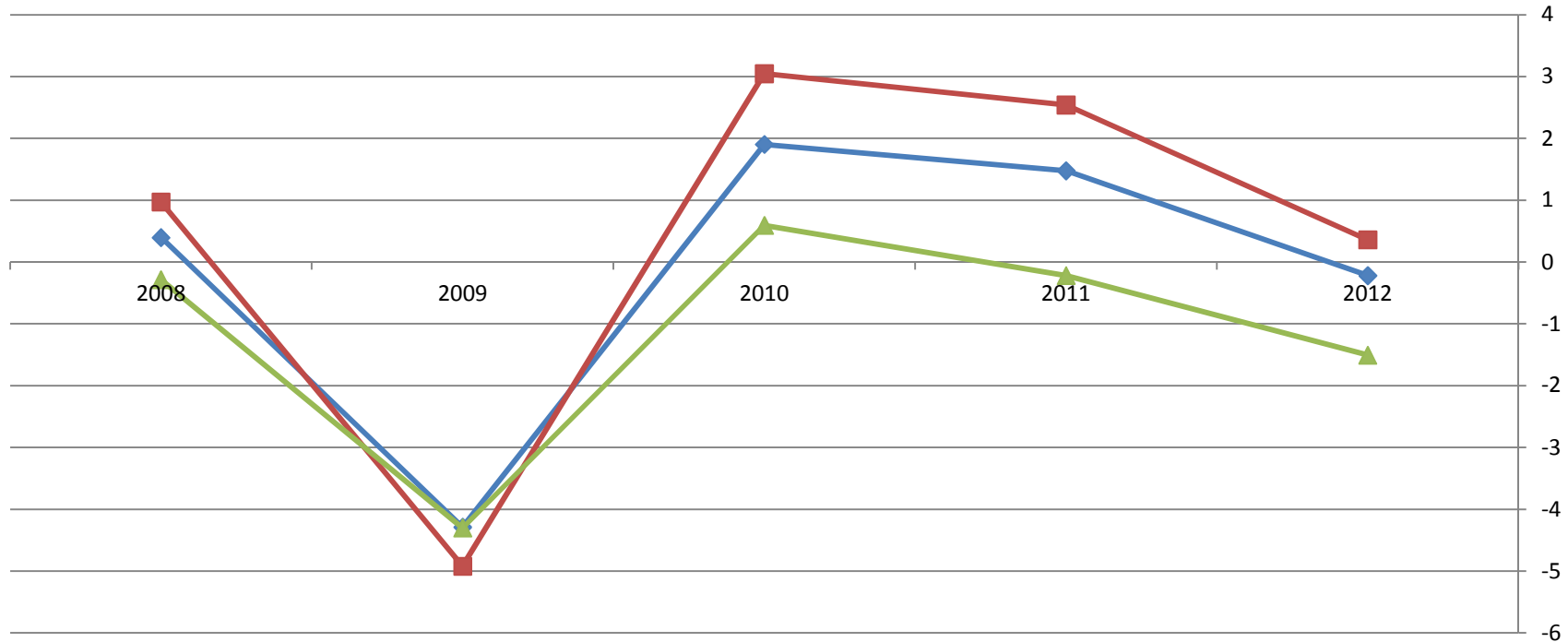
- In periphery: elevated risk premia, linked to:
- Sudden stop in cross border capital flows.
- Since risk premia are linked to external balance key issue is combination of fiscal/external adjustment.



# The 'real' problem

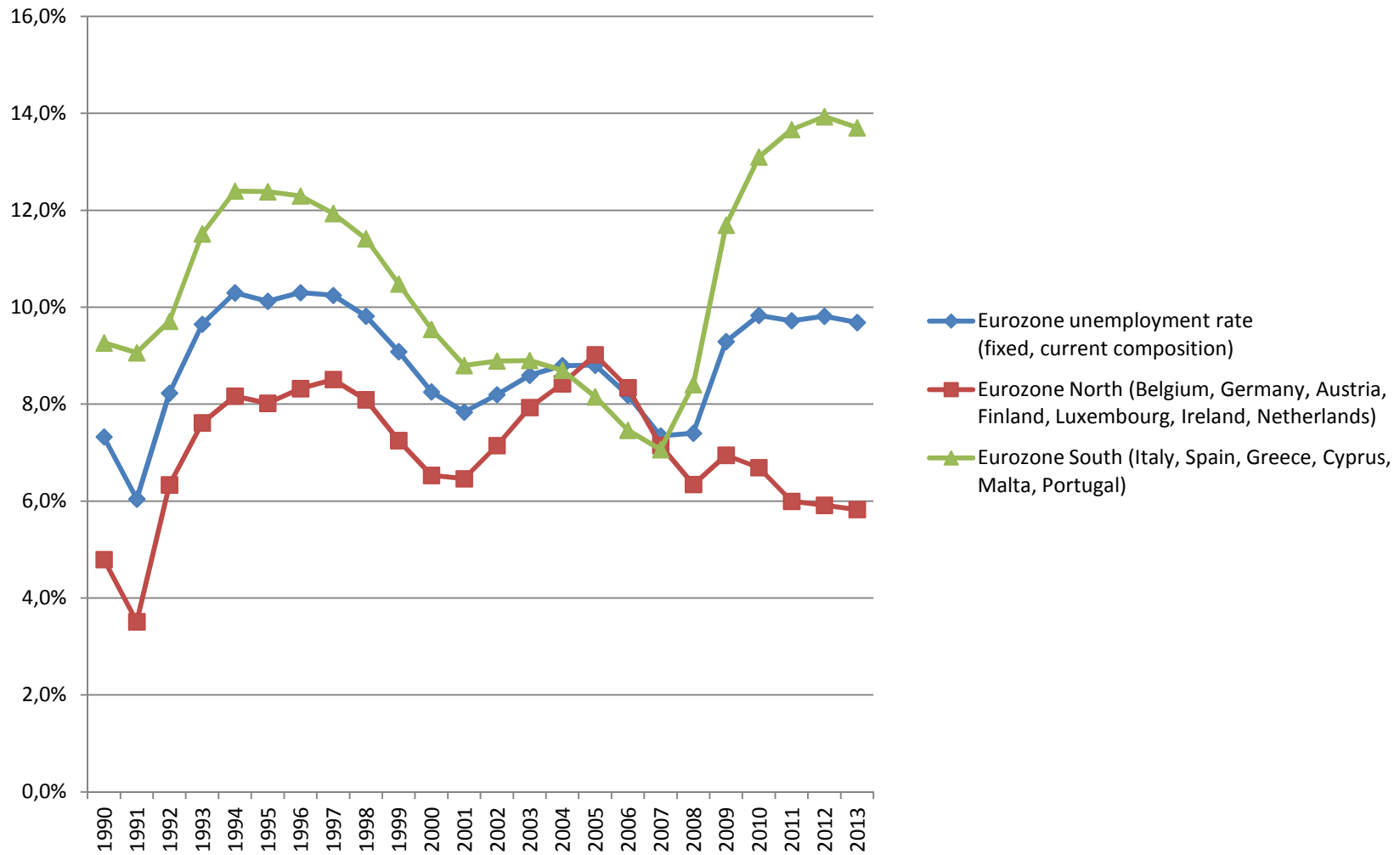
- Given the 'sudden stop' in cross border capital flows 'South' must close current account deficit.
- => In short run South needs to reduce consumption.
- => In long run needs to shift resources to exports (lower wages + structural reforms).
- Financial conditions key for depth of recession (in South).

## Real annual GDP Growth in percent (at 2005 market prices, weighed by corresponding GDP share)

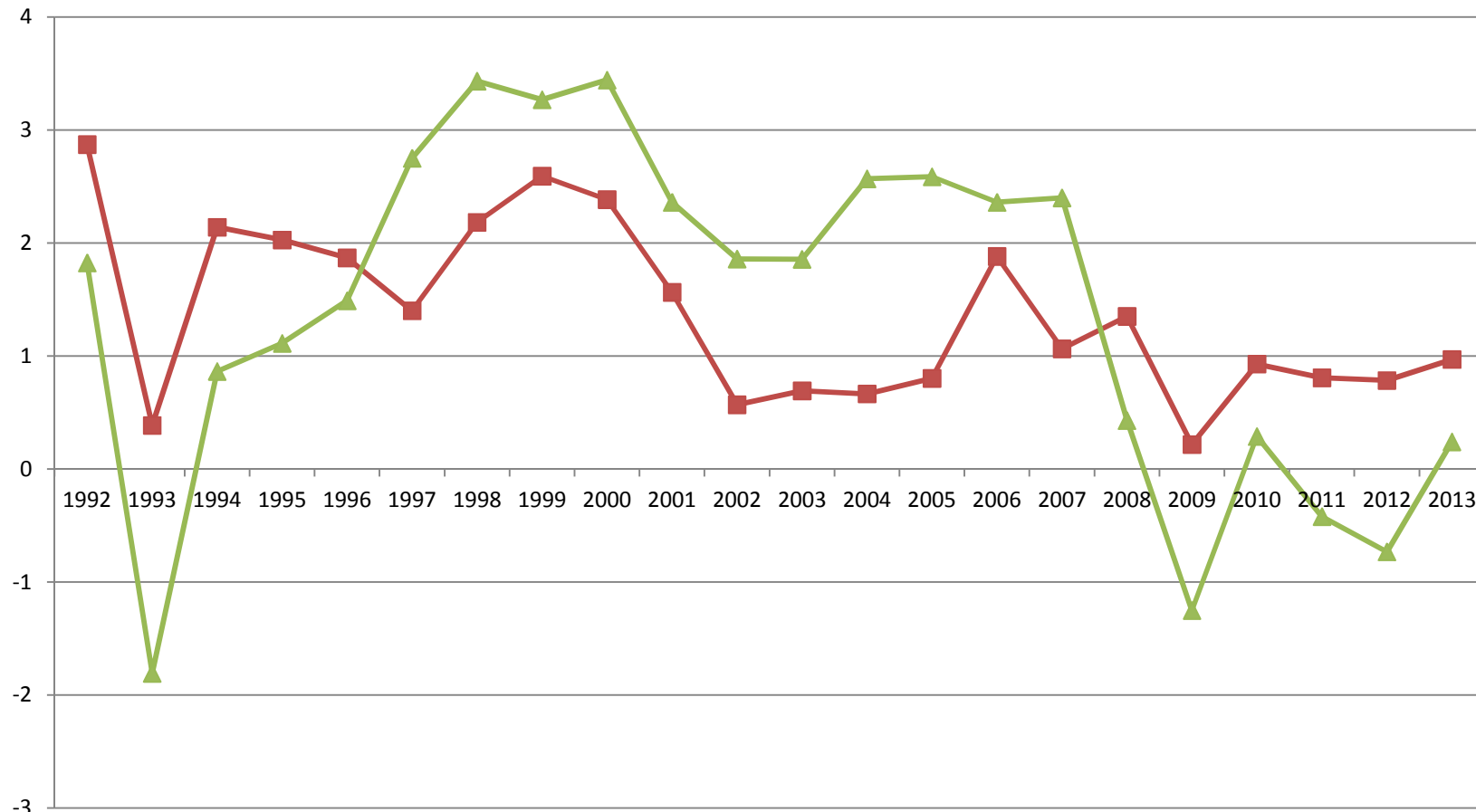


- ◆ Current Eurozone Total  
(Euozone North, South plus France, Estonia, Slovakia and Slovenia)
- Eurozone North (Belgium, Germany, Austria, Finland, Luxembourg, Ireland, Netherlands)
- ▲ Eurozone South (Italy, Spain, Greece, Cyprus, Malta, Portugal)

# Unemployment rate



# Real total consumption growth

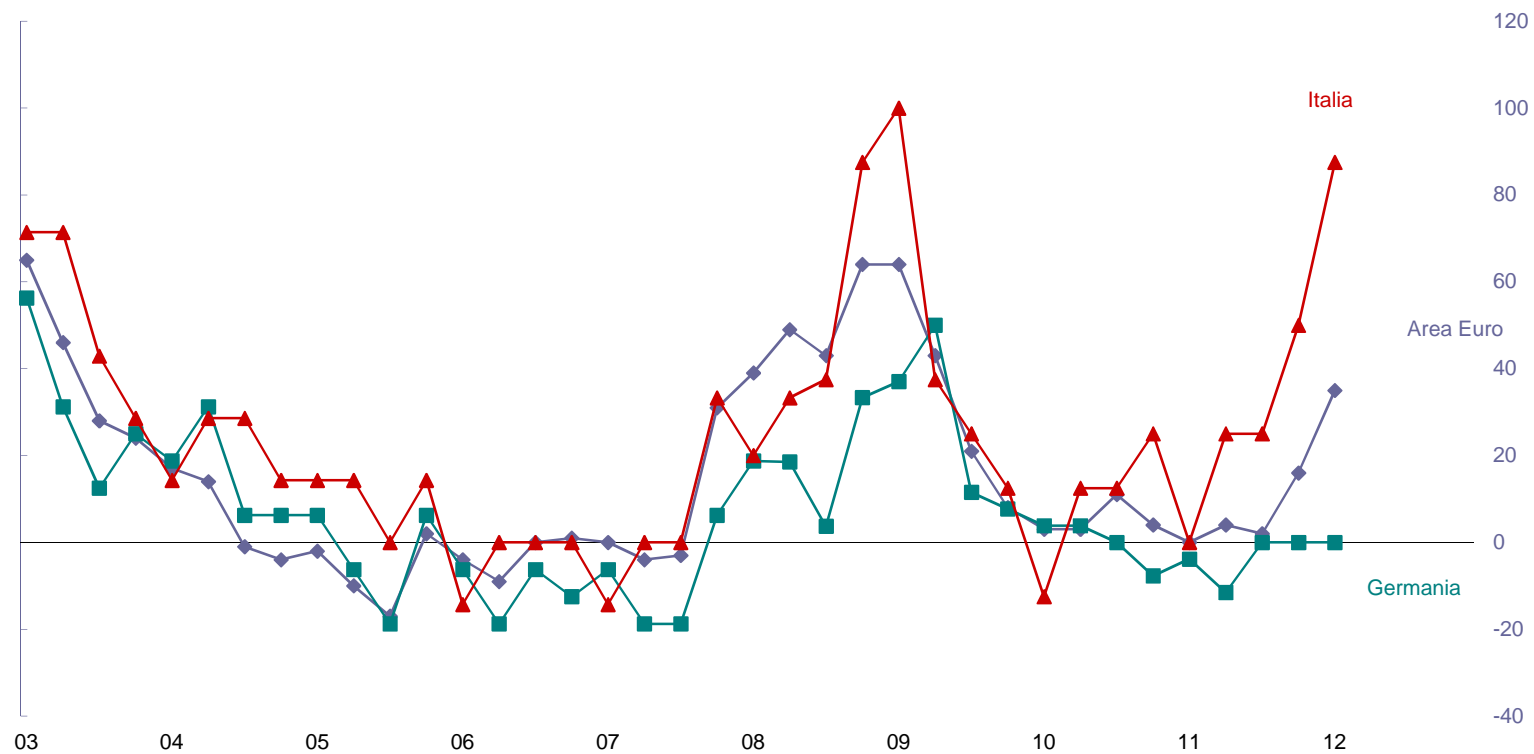


■ Eurozone North (Austria, Germany, Belgium, Luxembourg, Netherlands, Ireland & Finland) Mrd EURO  
▲ Eurozone South (Greece, Italy, Spain, Malta, Cyprus & Portugal) Mrd EURO

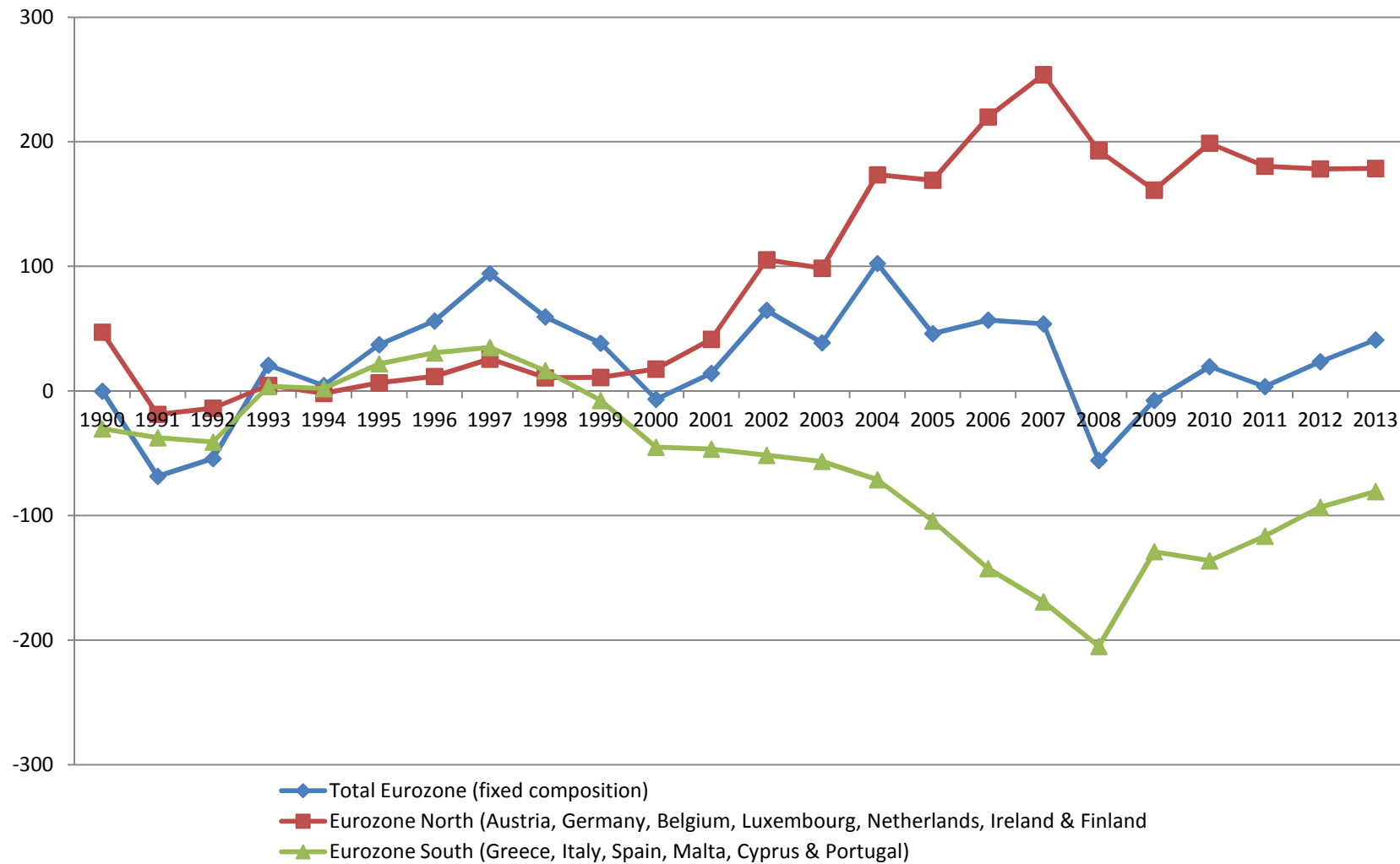
# A very selective credit crunch



Credit crunch indicator  
(% of bancs which tighten conditions)



# Current account (im)balances reduced but not eliminated







# What is desirable? What is feasible?

- Desirable: get South growing.
- Feasible:
  - a) Mitigate credit crunch and
  - b) accelerate shift of resources towards exportables (5 years instead of 10?).
- a) Credit crunch: ECB is key (and doing its part).
- b) Shifting labor: A question of additional investment or flexibility of markets (Spain)?

# Conclusions

- In euro periphery fiscal adjustment is unavoidable given the sudden stop of external finance.
- Policy should concentrate on lowering the cost of external adjustment and mitigate loss of output.

# Construction: a very special case



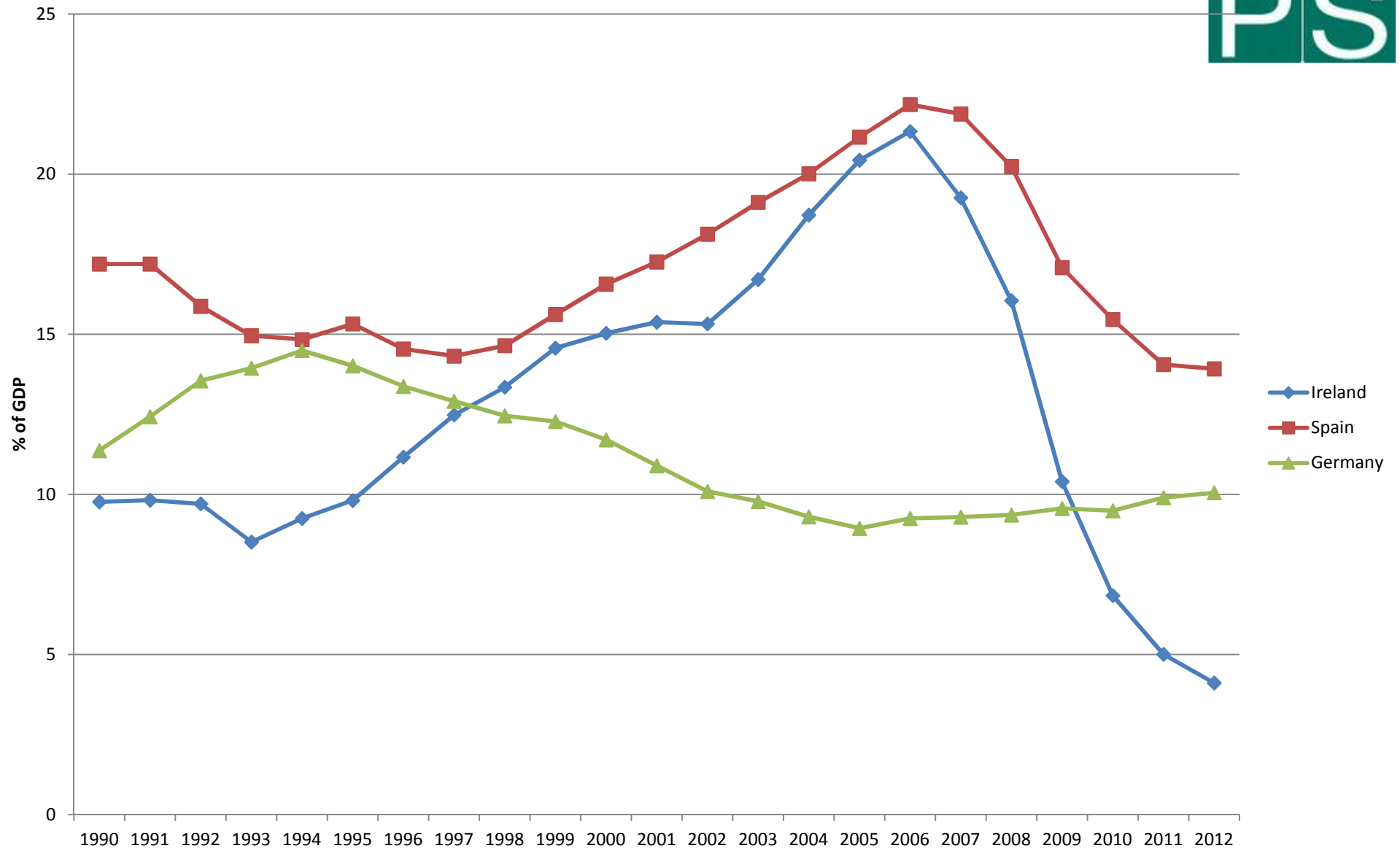
Long construction boom creates housing overhang.

Spain and Ireland:

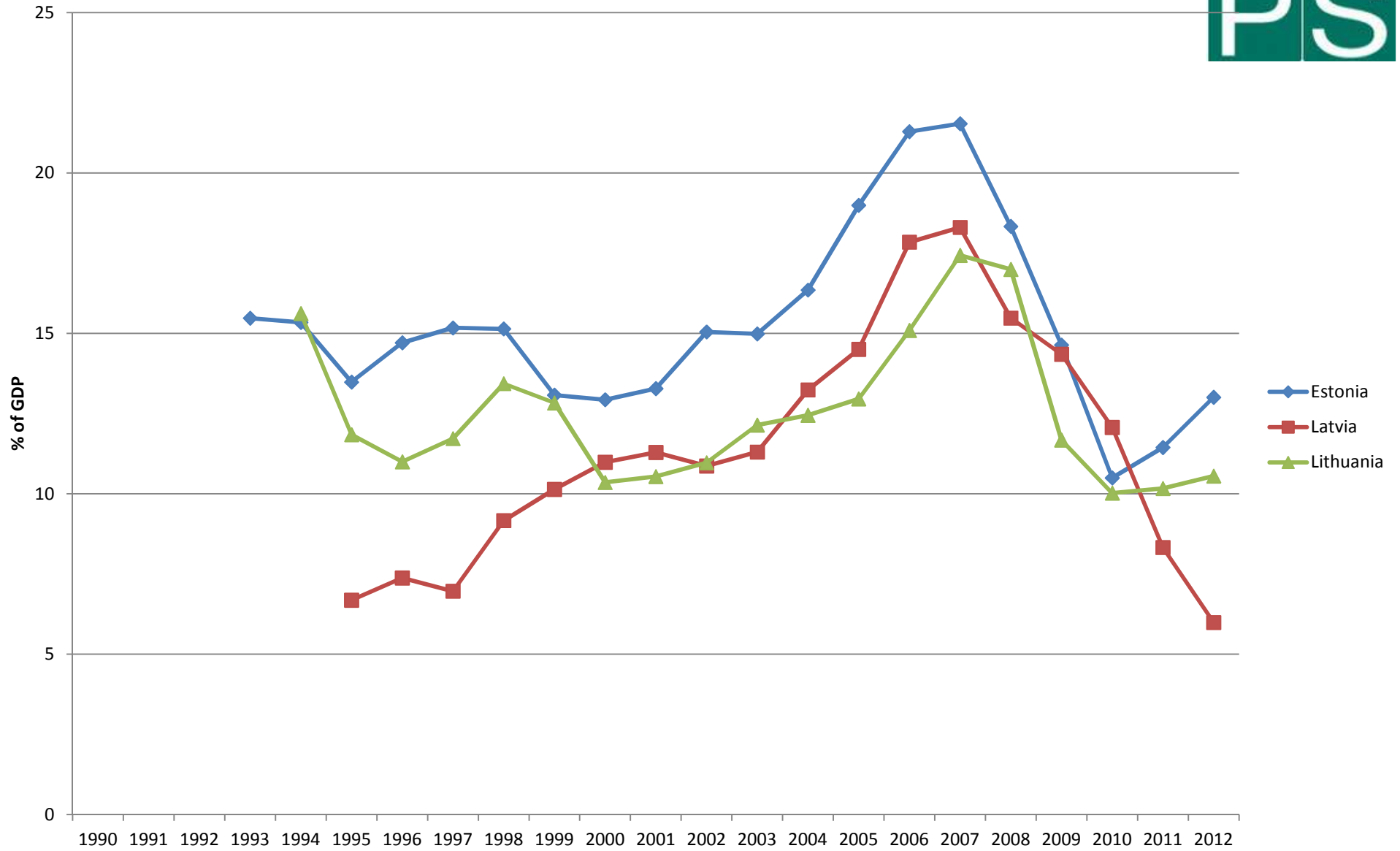
Many years needed to absorb (e. g. Japan after 1990  
and Germany after 1995).

Italy and France no significant overhang (=> price  
bubble alone does not matter much).

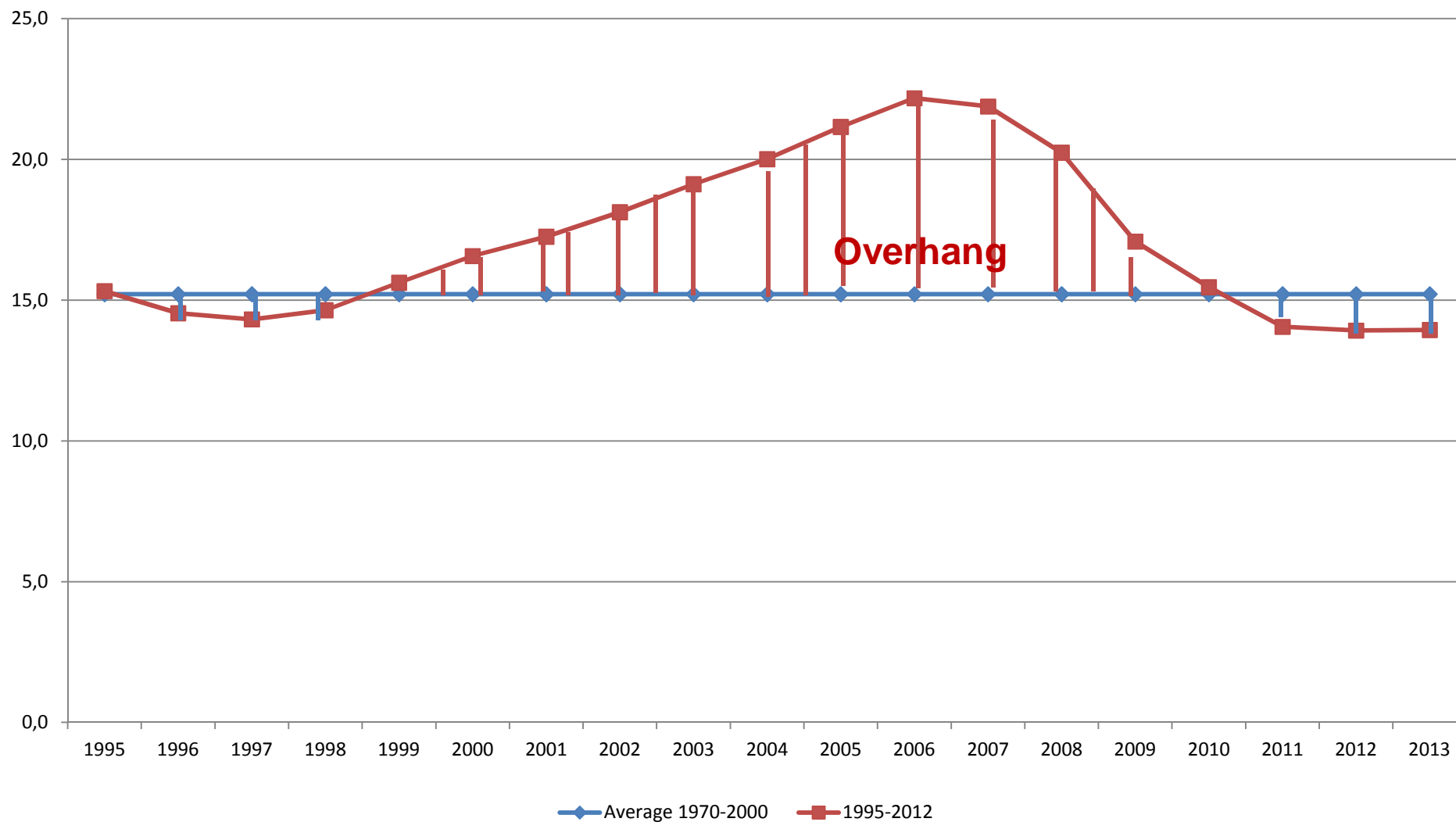
## Investment in Construction (% of GDP)



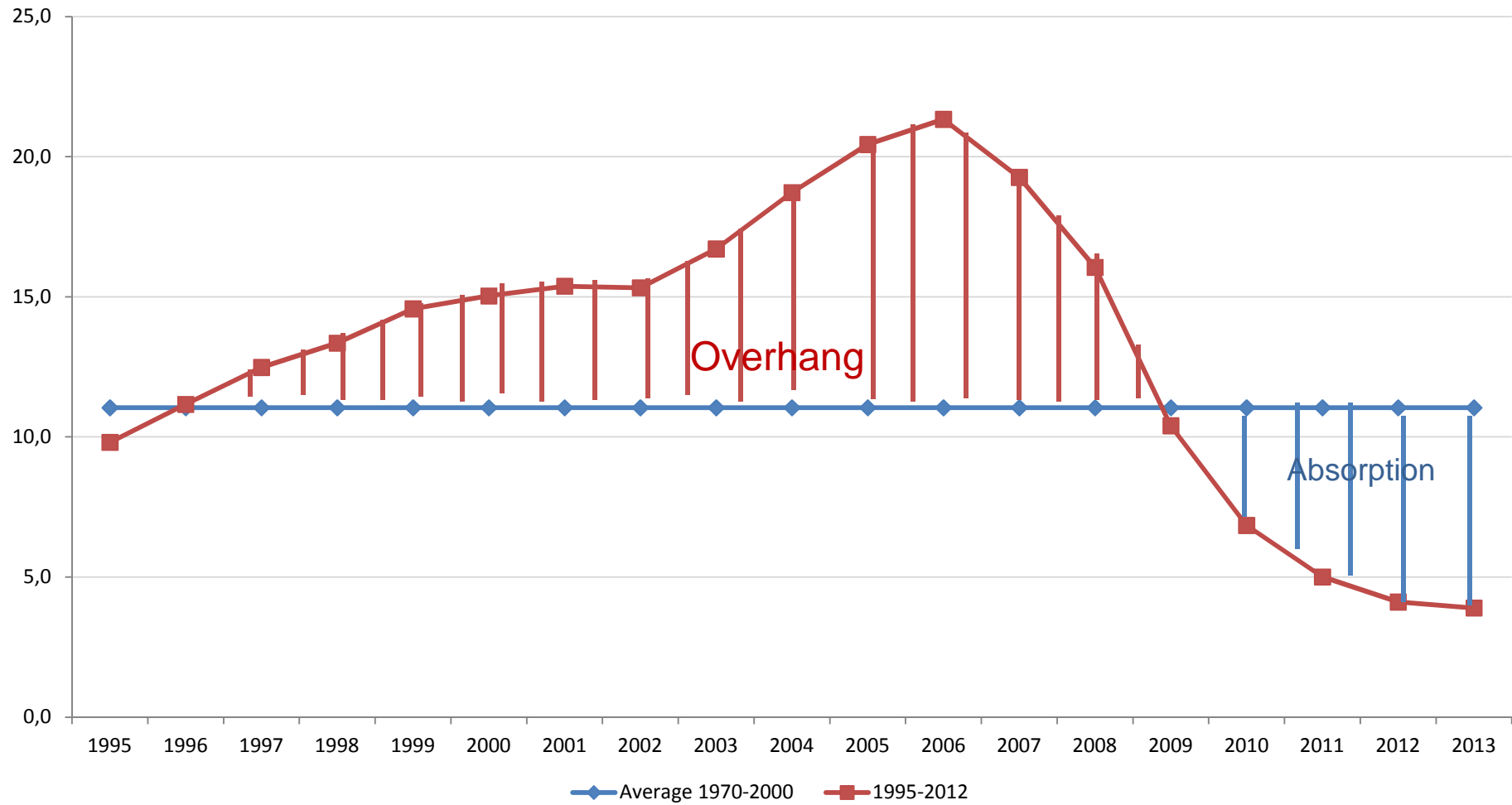
### Investment in Construction (% of GDP)



# Housing overhang continuing in Spain



# Housing overhang disappearing in Ireland





# Time needed to absorb overhang

## Spain

Years needed as of 2011 to absorb existing overhang with rate of construction 1.2% of GDP below normal: **32 Years**

## Ireland

Years needed as of 2011 to absorb existing overhang with rate of construction 7 % of GDP below normal: **8 Years**



# Germany's post unification problems: a cautionary tale



- Germany 1990 to 1995: post unification boom (construction and consumption) resulting in current account deficit and inflation.
- 1995-2005: hangover with low growth, high unemployment and high deficits. Growth returned when adjustment in construction sector was complete.