Box 7

THE CURRENT EURO AREA RECOVERY ACROSS EXPENDITURE COMPONENTS FROM A HISTORICAL PERSPECTIVE

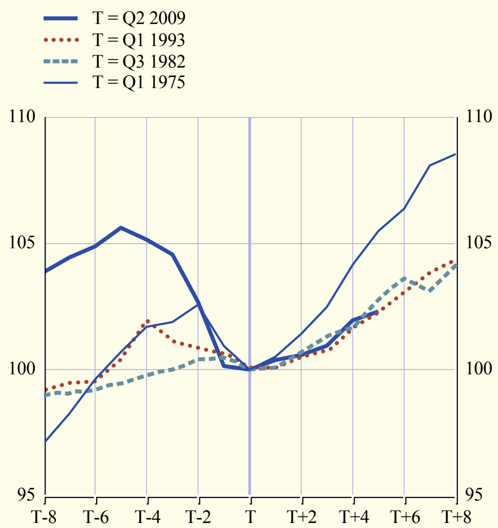
Euro area economic activity has been on a moderate recovery path since the trough reached in the second quarter of 2009, making up less than half of the output loss incurred during the preceding downturn. This box takes a closer look at developments in expenditure components during the current recovery and draws comparisons with previous euro area recoveries.

The recent downturn was sharper and deeper than its antecedents. Chart A presents a comparison of developments in GDP around the trough of the second quarter of 2009 with those during three previous euro area recessions since 1970, with T denoting the respective troughs. It shows that, while the size of the fall in GDP during the recent recession was twice that of the second steepest recession since 1970 (i.e. that of 1975, which followed the first oil price shock), the pick-up in GDP five quarters after the trough was among the weakest of the four recoveries. However, the relatively weak growth to date is consistent with the experiences of other economies following severe financial crises. In the aftermath of a financial crisis, demand tends to recover only slowly, owing to the need for extensive balance sheet repairs and deleveraging, while severe disruption within the banking sector also entails more prolonged credit constraints, which then hamper investment recovery.[1]

A snapshot of the cumulative GDP growth breakdown by expenditure component five quarters after the respective troughs for the four recoveries (see Chart B, right-hand bars) highlights the fact that there is little similarity between the current and previous recoveries in terms of the breakdown of GDP growth. In particular, the largest contribution to cumulative growth at the current juncture is being made by movements in inventories.[2] While a positive contribution from inventories during a recovery is not uncommon from a historical perspective, the magnitude and, especially, the timing of the contribution from inventories to the current upturn are. In terms of timing, in the current recovery, positive contributions stemming from inventories occurred immediately after the trough and were of considerable magnitude; whereas, in previous recoveries, positive contributions did not start to be observed until more than one year after the trough. This very

Chart A Euro area GDP across recoveries

(index: T = 100; T represents the trough in GDP)



Sources: Eurostat, AWM database and ECB staff calculations.

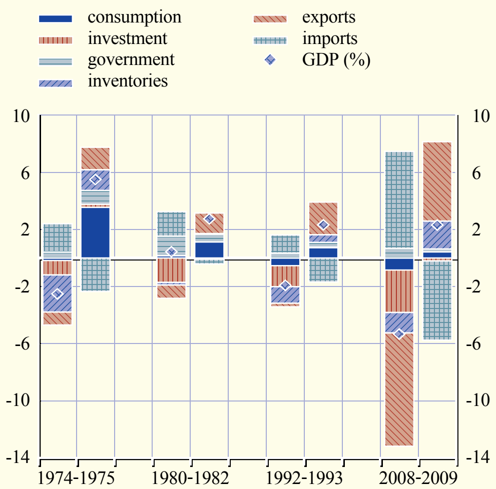
1 See the article entitled "The latest euro area recession in a historical context", *Monthly Bulletin*, ECB, November 2009, and "What's the Damage? Medium-Term Output Dynamics after Financial Crises", Chapter 4, *World Economic Outlook*, IMF, October 2009.

2 It should be noted that caution is generally needed when interpreting changes in inventories, given that they are the least reliable expenditure component.

early positive contribution, due to the pace of destocking slowing,[3] suggests that the pace of destocking reached its maximum level at the trough. This level was presumably judged to be excessive by firms and therefore subsequently reduced. The high rate of destocking during the recession was, to a large extent, determined by the severe tightening of financing conditions, which forced corporations to destock further in order to maintain cash flow, as well as by the dampening effect of the apparent fall in demand. Indeed, the level of destocking at the recent trough was significantly higher than previously observed. Recent information suggests a degree of restocking since the beginning of 2010.

Chart B Snapshot of cumulative GDP growth and its breakdown from peak to trough (left-hand bars) and five quarters after the trough (right-hand bars)

(cumulative contributions in percentage points; unless otherwise stated)



Sources: Eurostat, AWM database and ECB staff calculations.
Notes: The dates of the respective cyclical peaks in GDP are Q3 1974, Q1 1980, Q1 1992 and Q1 2008. The dates of the respective cyclical troughs in GDP are Q1 1975, Q3 1982, Q1 1993 and Q2 2009.

Another distinctive feature of the current recovery compared with the previous recoveries is the relatively small contribution to growth made by private consumption. Despite a much deeper contraction in the most recent downturn than in previous downturns (see Chart B, left-hand bars), private consumption has risen only modestly since the trough of the second quarter of 2009, making the smallest contribution to cumulative growth of all the four recoveries. Therefore, although it is the second largest factor influencing cumulative growth after the change in inventories, private consumption can be identified as a key factor determining the rather modest current pick-up in GDP relative to those previously recorded. This can, to a large extent, be explained by the broadly flat developments in aggregate real income, which are linked to the severity of the overall recession. In addition, consumption spending was also dampened by an increase in precautionary savings as a result of uncertainty about future income prospects. By contrast, the savings ratio actually fell during previous recessions and recoveries, part of a long-term decline which saw the household savings ratio fall by around 15 percentage points from the mid-1970s to the early 2000s. Nonetheless, current developments in both aggregate real income and the savings ratio suggest that further growth in private consumption is to be expected over the short term.

The third contributor to growth at the current juncture is public consumption, which in the past has also generally contributed positively to growth during recoveries, albeit playing less of a supportive role during the current recovery than in previous recoveries.

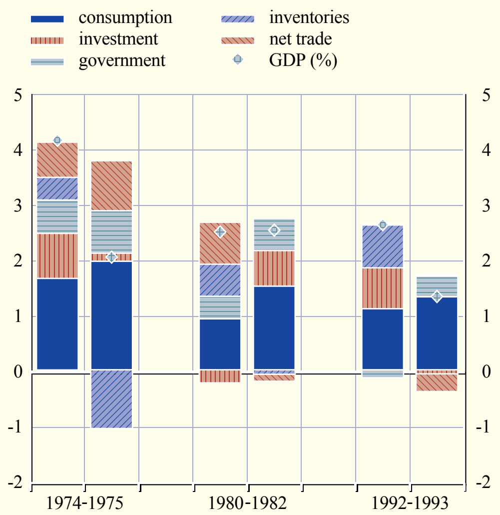
One characteristic shared by all recoveries is the generally very limited role played by total investment. Following recessions, firms typically have a degree of spare capacity, which they are likely to use up before undertaking any significant new investment. Indeed, the recent recession also saw a large drop in capacity utilisation. In addition, high uncertainty, low confidence and restricted financing conditions have dampened investment even further. The persistent tight credit

3 It has to be borne in mind that it is not the quarterly change in inventories itself that has an impact on the quarterly growth of GDP, but their rate of change. Thus, a positive contribution from inventories to GDP growth might come from either a slower destocking movement or from an intensification of the accumulation of stocks.

conditions and generally dampened demand have also made for a fairly weak contribution from investment during the recovery phase. Moreover, persistent declines in construction investment, observed mainly in those countries which previously enjoyed a housing boom, have also dampened investment growth in this cycle. Looking ahead, recent survey data and data on capacity utilisation rates suggest a continued revival in total investment in the euro area.[4]

Chart C Expenditure breakdown of annual GDP growth in the second year (left-hand bars) and the third year (right-hand bars) after the trough

(annual contributions in percentage points; unless otherwise stated)



Sources: Eurostat, AWM database and ECB staff calculations.
Note: The dates of the respective cyclical troughs in GDP are Q1 1975, Q3 1982 and Q1 1993.

By comparison with previous cycles, trade variables have shown far more marked developments in this cycle, both in their downward adjustment during the recession and their pick-up during the recovery. A sharp contraction in foreign demand following the intensification of the global financial crisis was the main factor influencing the collapse in global and euro area trade. However, both imports and exports bounced back sharply, mainly on the back of a vigorous rebound in the manufacturing sector and the various government support programmes that were introduced in many economies, such as car scrappage schemes. However, overall, the net contribution of trade to GDP growth has been broadly zero in this recovery, which is largely in line with previous experiences, when net trade generally made a positive, yet rather modest, contribution.

To summarise, by comparison with past recoveries, the current upturn in activity since the trough in 2009 has been relatively modest. This is consistent with previous findings, which have suggested that economies tend to recover only gradually following severe disruption in the financial system, such as that experienced over the past three years, mainly owing to weak private consumption and investment in the context of restricted credit flows. However, a comparison of the composition of growth also suggests that this recovery is different from previous recoveries in a number of respects. To date, this recovery has been much more reliant on inventories dynamics than previous recoveries. Growth in domestic demand has been muted, with consumption growth relatively modest, compared with previous euro area recessions.

Looking ahead, euro area activity is expected to maintain its gradual recovery. Experience suggests that, as recoveries strengthen and gain traction, there tends to be greater reliance on domestic drivers of growth (see Chart C, which shows developments two and three years after the respective troughs). In this respect, expected developments are likely to bring the euro area recovery path more into line with past experience. Thus, while the recovery of the world economy is expected to support demand for euro area exports, private sector domestic demand is also expected to gather pace and should increasingly contribute to the growth momentum of the euro area.

4 See Box 8 entitled "Investment outlook in the euro area: an assessment based on survey and capacity utilisation data" in this issue of the Monthly Bulletin.