Is the euro area out of recession?

By Philippe Weil

At its meeting on October 9th, the Euro Area Business Cycle Dating Committee of the Centre for Economic Policy Research (CEPR) in London drew on the OFCE for this thorny issue (for the composition of this committee, which I chair, see here). The Committee's mission is to establish a chronology of recessions and expansions in the euro area, similar to what the National Bureau of Economic Research has done for the United States, dating back to 1854.

This chronology is valuable in two ways.

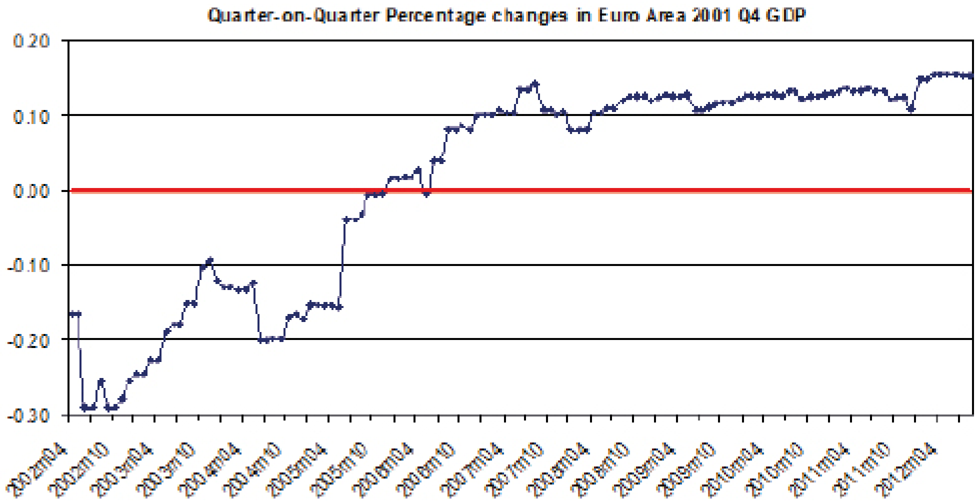
The first is that it allows economists to examine the characteristics of Europe's economic development. Do recessions tend to be short or long-lasting? Frequent or rare? Deep or mild? Is the euro area evolving in concert with the US economy? Is the slowdown in economic activity caused by the financial crisis unusual (more persistent than usual, sharper)? Without a clear definition of the timing of the ups and downs in Europe's economic activity and without a sketch of cyclical fluctuations, we cannot provide answers to these relatively basic questions.

The second advantage of this chronology is that establishing it requires an examination of all aspects of economic activity: GDP, of course, but also consumption, investment and especially employment (number of employed persons, number of hours worked). According to the CEPR's dating exercise, an expansion is a period in which every aspect of economic activity is growing significantly. It is not necessarily an episode of at least two consecutive quarters of GDP growth (much less one quarter!). For example, the CEPR Dating

Committee has determined that the countries composing the future euro area were in recession during the period from the 3rd quarter of 1980 to the 3rd quarter of 1982, whereas real GDP had risen for several quarters during this time and it was higher at the end of the recession than at the beginning! The culprits were investment and employment, which fell sharply during this period.

To add to the complexity of the dating effort, the harsh reality of the world of economic statistics should not be forgotten: the statistics reach us late and are subsequently revised, sometimes significantly, over time. Unlike meteorologists who know the temperature at the top of the Eiffel Tower in real time, economists have no idea, for example, of the level of GDP for the current month or quarter. The first estimates are released only several months later (*e.g.* the first flash estimate of euro area GDP for the third quarter of 2013 will be published by Eurostat only on 14 November 2013), and it might turn out that growth rates that seem positive based on preliminary estimates wind up after subsequent revisions to be negative – or vice versa. By examining all the determinants of economic activity (including employment), and not just GDP, the Committee is guarding against (so far successfully) the imperfections in this data so as to avoid, for instance, declaring the existence of a recession which turns out to be a statistical mirage that disappears after further review of the data. Thus, the Committee did not report in September 2003 the existence of a recession between 2001 and 2003 even though the data showed a decrease in GDP during that time (but never, it is true, for two consecutive quarters). It concluded that there had been a prolonged pause during a period of expansion. This was a good move, as subsequent revisions of GDP cancelled these quarters of declining economic activity (see Figure 1). Its diagnosis was thus well advised.

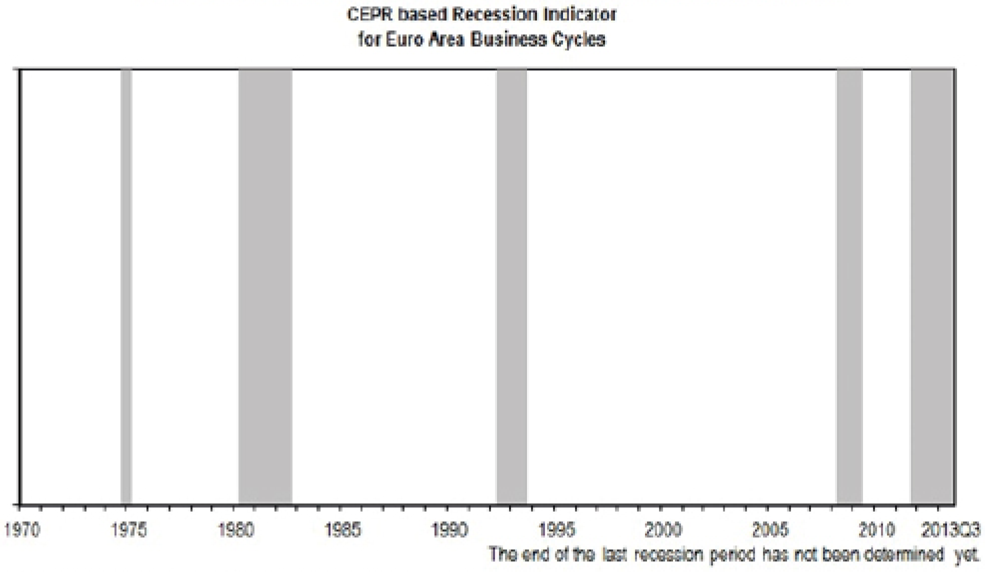
Figure 1. Quarter-on-quarter Percentage Changes in the Euro Area 2001 Q4 GDP (relative to the previous quarter)



Source : ECB Monthly Bulletin.

So let’s get back to the euro area in the state we see it in October 2013. The area hit a peak in economic activity in the 3rd quarter of 2011 and, since going into recession at that time, it experienced quarterly growth that was slightly positive in the second quarter of 2013. The first estimate for the third quarter of 2013 will not be known, as mentioned earlier, until 14 November. There are, it is true, several corresponding indexes indicating that the cycle is in an upwards phase and that the macroeconomic outlook for 2014 is more favourable. But on 9 October the Dating Committee noted, nevertheless, that it would be premature at that time to conclude that the euro area was out of recession. Indeed, neither the length nor the strength of the putative recovery in economic activity was sufficient to conclude that the recession was already over. This judgment was not based on the absence at that point of two consecutive quarters of GDP growth because this is not the criterion that (mechanically) guides the Committee’s thinking. Nor does it reflect any pessimism about the economic outlook for 2014, because the Committee is not in the business of making predictions. The Committee’s assessment is based simply on a review of all the data available at the time it meets. The Committee has not excluded that the euro area is simply going through a pause in the recession it entered a year ago.

Figure 2. CEPR-based Recession Indicator for Euro Area Business Cycles



Note : The grey bands correspond to periods of recession as evaluated by the CEPR. Whether the latest period of recession is over has not yet been determined.

Roofs or ceilings?

by [Philippe Weil]

The [bill to promote access to housing and urban renovation] provides for regulating rents "mainly in urban areas where there is a strong imbalance between housing supply and demand and where rents have experienced the steepest increase in recent years". Rents that exceed the median rent, set by neighbourhood and housing type, by more than 20% "will be targeted for a reduction". The purpose of the cap is of course laudable, as it is "designed to combat the housing crisis, which for many years has been characterized by a sharp increase in prices, housing shortages and a decline in consumer purchasing power". The road to hell is, alas, paved with good intentions, as today's ceilings often destroy tomorrow's roofs :

- "Rent ceilings […] cause haphazard and arbitrary allocation of space, inefficient use of space, retardation of new construction and indefinite continuance of rent ceilings, or subsidization of new construction and a future depression in residential building. Formal rationing by public authority would probably make matters still worse."

Opposing rent ceilings does not mean, however, resolving the inequalities that arise with respect to housing:

- "The fact that, under free market conditions, better quarters go to those who have larger incomes or more wealth is, if anything, simply a reason for taking long-term measures to reduce the inequality of income and wealth. For those, like us, who would like even more equality than there is at present, not alone for housing but for all products, it is surely better to attack directly existing inequalities in income and wealth at their source than to ration each of the hundreds of commodities and services that compose our standard of living. It is the height of folly to permit individuals to receive unequal money incomes and then to take elaborate and costly measures to prevent them from using their incomes."

The authors of these two quotes, which enjoin us to allow the free market system to allocate the available housing to tenants and which advocate attacking inequality of income and wealth directly at the source, are none other than Milton Friedman and George Stigler – the two founders of the Chicago School. The title of this post is borrowed – I hope they forgive me – from their 1946 article *"Roofs or Ceilings: the Current Housing Problem"* [1].

The Duflot bill envisages a rent control mechanism that is far more sophisticated than the one denounced by Friedman and Stigler nearly seventy years ago. Its impact on the French real estate market can of course be evaluated in a few years, but the recent economic literature warns that so-called “second generation” rent control mechanisms often have ambiguous effects [2] – not always negative but not necessarily positive [3]. In these circumstances, it is regrettable that a preliminary experiment of the sort that prudence demands is not being considered for some randomly selected cities. While political urgency undoubtedly argues against delay, nevertheless in economics as in medicine it is crucial to ensure that efforts to cure the patient do not wind up killing him.

To conclude, the warning of Friedman and Stigler still holds: inequalities in income and wealth need to be attacked directly at the source, and not later down the line.

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[1] Foundation for Economic Education, Irvington-on-Hudson, NY.

[2] *Cf*., for example, *The Economics and Law of Rent Control*, by Kaushik Basu and Patrick Emerson, World Bank, 1998.

[3] Please see Le Bayon, Madec and Rifflart (2013) [in French] for an evaluation of the regulation of the French rental market.