Growth to Ease in Europe and China, Strengthen in U.S.

Japan and New Zealand are certainly in recession. With Spain probably in the same camp and Italy and U.K. teetering on the edge of recession, policy choices are unusually fraught with danger.

Soft Spots Late last year, we warned that Japan and New Zealand were on the cusp of recession (↗*International Cyclical Outlook, Vol. XV, No. 12, December 2010*). Today, there is little doubt that those economies are indeed contracting.

Some might attribute those downturns to the tragic natural disasters that both countries have recently experienced, but the data show that the recessions actually began months earlier. This is analogous to the 2001 U.S. recession, which many blamed on the September 11 attacks though the economy had actually been contracting for the prior six months.

Separately, some are now hoping that New Zealand may have dodged a recession just because, after shrinking in the third quarter, its GDP rose a bit in the fourth quarter of 2010 – even though employment, income and sales all fell. Again, this is like saying the U.S. did not have a recession in 2001 because its GDP did not decline for two straight quarters, although it suffered bigger job losses than in any recession in the previous 50 years.

Such confusion is rooted in the erroneous belief that "two down quarters of GDP" constitutes the "technical definition" of recession, even though, in reality, it is nothing of the sort – merely a popular but flawed rule of thumb that is neither a necessary nor a sufficient condition for a recession. This is especially relevant today in the case of the Spanish economy, which is almost universally believed to have exited recession at the end of 2009, because it apparently saw positive GDP growth in 2010. As is often the case, it is worth examining the facts.

According to the latest official data, Spanish GDP edged up by less than 0.1% in the first quarter of 2010, and by 0.3% in the second quarter. It then saw marginally negative GDP growth (originally reported as slightly positive) in the third quarter before rising by 0.2% in the fourth quarter. In other words, at the end of 2010, Spanish GDP was less than 0.6% above its year-ago level.

Clearly, it would not take much of a revision to wipe away the entire one-year gain in GDP. Of course, GDP releases are based on many estimates that are especially susceptible to revision near business cycle turning points.

Among the other key coincident indicators of the Spanish economy, industrial production has declined since August, having gone essentially nowhere over the past two years. Even worse, with personal income

Divergent Outlooks

	Current Growth	Consensus Growth Outlook	ECRI Growth Outlook
↗U.S.	Average	Average	Average
↗Canada	Slow/Average	Average	Slow/Average
↗Mexico	Average	Average	Average
↗Germany	Average	Average	Average
↗France	Average	Average	Slow/Average
↗U.K.	Slow/Average	Slow/Average	Slow
↗Italy	Slow	Average	Slow
↗Spain	Recessionary/Slow	Slow/Average	Recessionary/Slow
↗Switzerland	Slow	Average	Slow
↗Sweden	Average	Average	Average
↗Austria	Average	Average	Slow/Average
↗Japan	Recessionary	Recessionary/Slow	Recessionary
↗China	Average	Average	Average
↗India	Average	Average	Average
↗Korea	Slow/Average	Average	Average
↗Australia	Slow/Average	Slow/Average	Slow/Average
↗Taiwan	Average	Average	Average
↗New Zealand	Recessionary	Recessionary/Slow	Recessionary
↗South Africa	Slow/Average	Average	Slow/Average

FOCUS: U.K. Outlook

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dropping to a five-and-a-half-year low, retail sales have plunged to the lowest reading in over 11 years. Finally, employment has fallen to its lowest level in more than six years, while the jobless rate has climbed to a 13-year high. No wonder ECRI's Spanish Coincident Index has now declined to its worst reading in nearly eight years *(Chart 19a, page 26)*. This decline is the hallmark of an unbroken three-year recession, not a recovery that began more than a year ago.

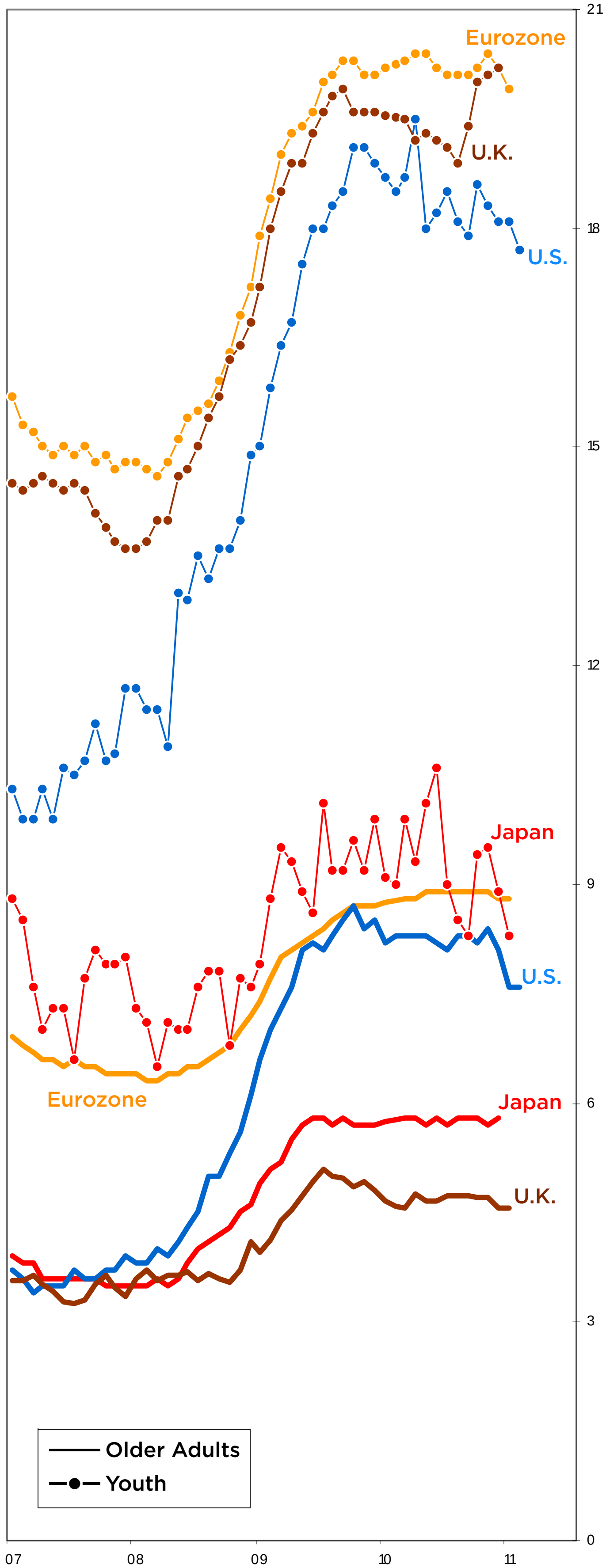
Given the current concerns in the Eurozone, this is an awkward time to face such facts, but they should not be surprising *(International Cyclical Outlook, Vol. XV, No, 5, May 2010)*. It does not help that a Spanish economic recovery has yet to appear on the horizon *(page 26)*. Meanwhile, the Italian recovery is still fragile *(page 24)*. All this makes it particularly inopportune for the European Central Bank (ECB) to be hiking interest rates in the near future.

The ECB's hawkish posture is understandable, coming in the wake of rising underlying inflation pressures, especially in Germany *(page 17)* and France *(page 19)*. Yet, this policy shift is an about-face from the ECB's complacency at the beginning of the year, when a Reuters story juxtaposed the report of a further rise in ECRI's Eurozone Future Inflation Gauge against the news that Mr. Trichet "saw no danger of inflation taking off in the euro zone, dismissing any concerns about rising price pressures in the currency area." He added that price stability was secured "for the foreseeable future too." Perhaps, in the parlance of central bankers, the foreseeable future means just a few days as, less than a week later, Mr. Trichet began warning of the need for vigilance against inflation.

The situation for the Bank of England (BoE) is also quite awkward. U.K. inflation is already more than twice the BoE's target level, and underlying inflation pressures have resumed their advance *(page 21)*. Yet, as we discuss in detail, the British economy is currently in a precarious position in terms of its cyclical situation *(pages 7 to 9)*.

Thus, a quick survey of the globe shows us that two island nations on the Pacific Rim are already in recession, while the U.K. and the economies of Southern Europe are in recession or teetering on its brink. Thankfully, economic growth is likely to pick up further in the U.S. and in some smaller economies that are heavily dependent on the exports of manufactured goods (specifically, Taiwan, Korea and Mexico), but overall economic growth in almost all other economies is set to slow further in the next few months.

Chart 1a: Jobless Rates (%) for Youth and Older Adults in Developed Economies



Certainly, China and India have serious inflation problems that we discussed in detail three months ago (*International Cyclical Outlook, Vol. XV, No. 12, December 2010*). Since then, India has taken a number of measures to fight inflation, which is not yet under control. China too has taken numerous steps to curb inflation, and while there are tentative indications that inflation may begin to ease off in the coming months, China may keep tightening policy.

Yet, according to ECRI's Chinese Long Leading Index, Chinese economic growth, which is already slowing, is quite likely to ease further *(page 33)*. Under the circumstances, it is not surprising that German economic growth is also set to moderate in the coming months *(page 18)*.

In consequence, even though we should soon see cyclical upturns in areas ranging from the growth rate of Australian commodity and fuel exports *(page 30)* to Mexican export growth *(page 10)*, Eurozone economic growth will continue to ease in the coming months *(page 16)*. In that context, the combination of fiscal austerity measures and monetary tightening in the Eurozone is likely to impact the economy at a delicate juncture, especially in view of the parlous state of unemployment.

Idled Youth Among major developed economies, Germany's economic recovery is widely admired, and with good reason. It has already added three times the number of jobs lost during the recession compared to the United States, which has regained barely one-seventh of the lost jobs.

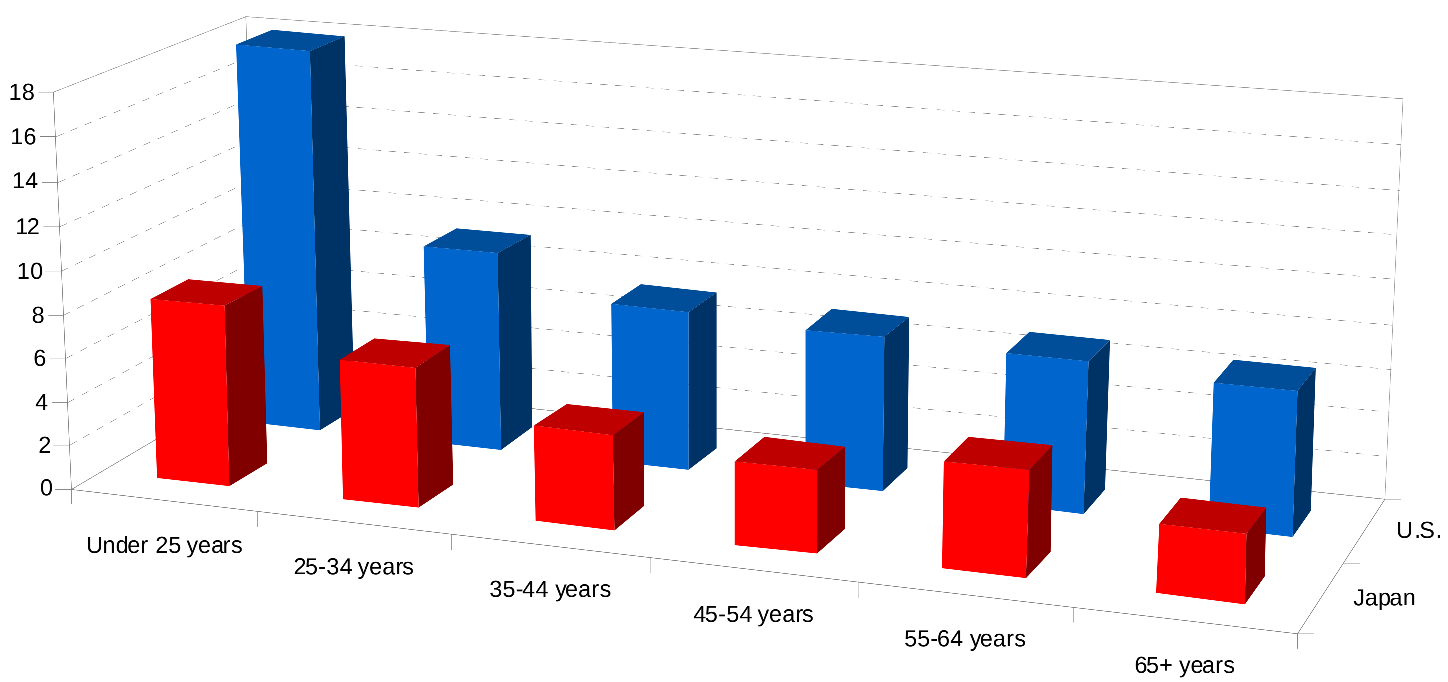
Yet, in terms of GDP, the U.S. revival is actually more impressive, as it has already surpassed its pre-recession peak, while German GDP has regained only 78% of the lost ground. In other words, Germany has had a more labor-intensive revival.

The German unemployment rate has fallen to its lowest reading in nearly 19 years. However, the Eurozone as a whole, like the U.S., saw a recessionary surge in the jobless rate, with the jobless rate for those under 25 years of age, in particular, skyrocketing.

The four thinner lines with dots in Chart 1a show these jobless rates for under-25 youth for the Eurozone (gold), the U.K. (brown), the U.S. (blue) and Japan (red). These are the top four lines in the chart.

The four thick lines on the same chart also show the jobless rates for older adults, aged 25 years and over, for the Eurozone (gold), the U.K. (brown), the U.S. (blue) and Japan (red). These are the bottom four lines in the chart.

Chart 1b: Pattern of Jobless Rates (%) **by Age Group in Japan and U.S.**



Clearly, the recession boosted all the jobless rates substantially. However, the jobless rates for adults aged 25 and over still remain in the mid-to-high single digits in all four economies. In contrast, the youth jobless rate went from the mid-to-high single-digit range to low double digits as a result of the recession in Japan, while it zoomed from around 10% to almost 20% in the U.S. case. In the U.K. and the Eurozone, the youth jobless rates soared from the mid-teens to around 20%. Quite simply, the younger age group has been badly affected by the recent recession, with a twelfth of them being jobless in Japan, and about a fifth of them rendered jobless in Europe and the U.S.

Chart 1b shows the jobless rates by age group for Japan and the U.S. In both cases, the youngest age group (under 25) is the worst-affected. In both economies, the jobless rate decreases progressively with rising age, with the minor exception being the 55-64 age group in Japan, for which the jobless rate is higher than those in the 35-54 and 65+ age groups. In any case, the clear standout – towering above the rest – is the jobless rate for Americans under 25.

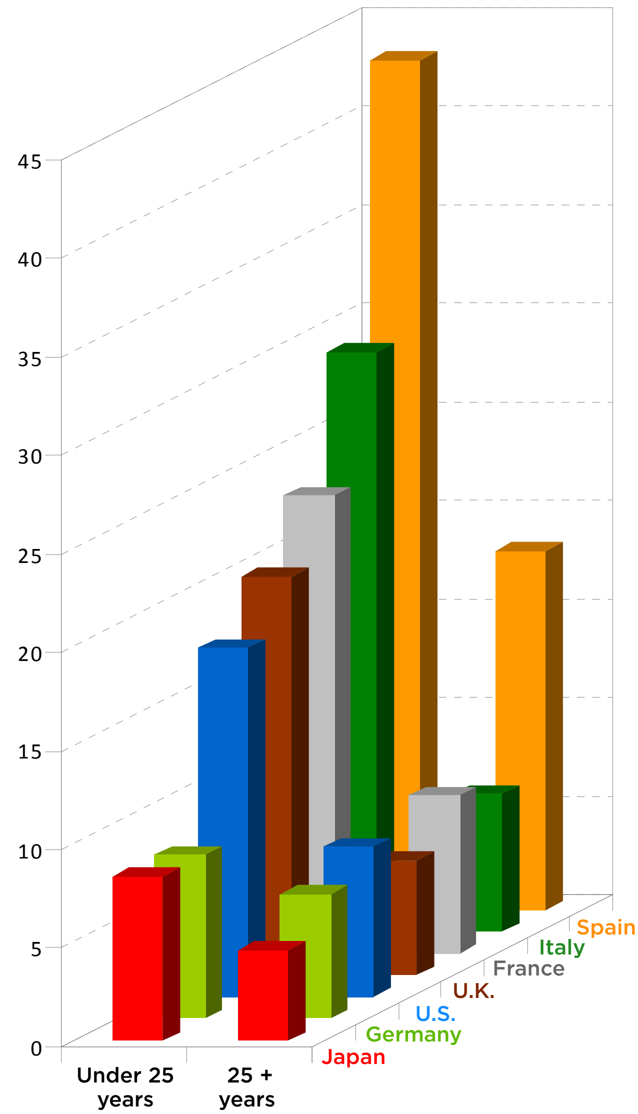
This is a sharp reversal of the situation that prevailed even at the turn of the century. For example, in 2000, only 29% of men in their sixties held jobs compared with 34% today, but 34% of 16- and 17-year-old males held jobs in 2000, compared with less than 15% today.

Evidently, older Americans are less likely to have lost their jobs during the recession, but the median duration of unemployment rises steeply with age (not shown), meaning that the older one is, the longer it takes to find a new job. One might imagine, therefore, that most of the "discouraged" workers who – because of the poor labor market – have looked for a job in the past year but not in the last month, are older people. However, the data show that the prevalence of discouraged workers largely declines with age (not shown), but with those in the 25-34 age group showing the highest incidence of such "discouragement."

Why should this be? One explanation may be that older workers cannot afford to stop looking for work, since they can rarely move back with their parents, and also have family responsibilities that they cannot shirk. The younger jobless, however, can afford to take a break more easily when they encounter a tough job market. Also, with many of their peers also in the same boat, the stigma of being unemployed may be significantly reduced.

Unemployment is consistently higher among the youth than among older adults – not only in the U.S. and Japan, but also in Europe. As Chart 1c shows, the under-25 jobless rate in Japan and Germany, though under 10%, is substantially higher than for older workers. The disparity is much higher for the U.S., where the youth jobless rate is about 18%, and for the U.K., where it is over 20%. This is even more so for France, where the youth unemployment rate is over 23%, and for Italy, where it is nearly 30%. But the worst of the larger Eurozone economies is Spain, where more than 43% of those under 25 are unemployed. For the Eurozone as a whole, the youth unemployment rate is 20%, a bit higher than in the U.S.

Chart 1c: Jobless Rates (%) for Youth and Older Adults in Major Developed Economies



To get a sense for the disaffection such a situation can create, it is worth recalling that the high jobless rates among the young, which are often implicated in the revolution sweeping across North Africa and the Middle East, is in the same ballpark. Specifically, the under-25 jobless rate is estimated to be around 25% in Egypt, Qatar and Saudi Arabia, as high as 31% in Tunisia, and in the range of 40% to 50% in Libya.

One key difference with the advanced economies, of course, is not only political repression, but also the demographic dominance of the youth in most Muslim countries. In particular, the median age is typically under 25 years in many such countries and around 30 years in others. In Pakistan, where the median age is only 21 years, according to some estimates, anecdotal evidence suggests that the youth unemployment rate has surged in recent years.

The global recession's harshest legacy may be the staggering level of youth unemployment in most developed economies.

In Tunisia, many of the desperate young people who helped spark the revolution are called *hittistes* – French-Arabic slang for those who lean against the wall. Their Egyptian equivalents are the *shabab atileen*, or unemployed youths.

Such youths have counterparts in most developed economies. In Britain, they are called *NEETs* (not in education, employment, or training). In Spain, we find the *mileuristas*, meaning that they earn less than 1,000 euros a month.

In Japan, they are *freeters* – a word combining the English "freelance" with the German "Arbeiter," or worker – an underclass of young people who hold transient, lower-paying irregular jobs. Of course, many freeters who live with their parents are derided as "parasite singles" (a subset of these are the *hikikomori* – reclusive people who have chosen to withdraw from social life). In the five years to 2009, the biggest jump in Japanese singles living with parents was among men aged 35 to 39 years, whose numbers surged eight percentage points to 42%.

In Italy, such youths are sometimes disparaged as *bamboccioni*, meaning big babies, who still live with their parents. Even in Germany, those still living at what some call *Hotel Mama* are derisively known as *Nesthocker* (a bird that stays a long time in the nest).

In North America, the slang is gentler, referring to "boomerang" kids, who move back home after college because they cannot find work – or at least well-paying jobs. Some of them may belong to the class disparaged by some as slackers or the *slackoisie*, who, according to one definition, are narcissistic young professionals who think a job is an entitlement, not a privilege, and therefore complain about their job (if they have one), and decry the lack of "real" jobs while criticizing the long hours and inadequate pay at most small firms.

It should be obvious from the scornful epithets used to describe them that, across a wide range of societies, youth who end up unemployed or underemployed are often viewed with contempt. Yet, while some may have poor attitudes, it is surely unfair to blame them entirely for the unenviable predicaments in which they find themselves.

It is possible that some young people have grown up with unrealistic expectations. But the larger reality is that, precipitated by the recession, a whole range of jobs has simply disappeared in many economies.

In the 34 industrialized nations in the Organization for Economic Cooperation and Development (OECD), some 17 million youths are not employed, in school, or in training, and about 10 million of those are not even looking, according to the OECD. In the most developed nations, many of them are not qualified for the available high-paying jobs, and cannot live on the available low-paying jobs. In short, many of the jobs requiring mid-level skills that spanned the divide between these two types of jobs have been automated or outsourced.

This is the harshest legacy of the Great Recession, which panicked businesses into embracing sweeping changes – whether by speeding up the adoption of already-available cost-saving technologies, or through outsourcing tasks to cheaper locations. There were simply not enough jobs left for those who lost their jobs or entered the labor force during a recession that triggered changes in the skills demanded at a much faster pace than it was possible to change the skills of job-seekers.

The few advanced economies that experienced milder youth unemployment – such as Germany – did so in part because of blue-collar apprenticeship programs. Accordingly, the budget announced this week by the British Chancellor of the Exchequer, George Osborne, aims to quintuple the number of places on a government-funded work experience program, subsidize tens of thousands of new apprenticeships and, in an attempt to improve technical skills, fund 24 new university technical colleges that specialize in technical skills, along the lines of the German Realschule. It remains to be seen how successful such efforts will be in economies that are not as industrially oriented as Germany.

Doubling Down In the face of enormous unemployment and massive deficits bequeathed by the recession, policymakers are rushing to institute fiscal austerity measures, along with monetary tightening (in Europe), or have boosted fiscal stimulus and dramatically eased monetary policy (in the U.S.) in the hope of averting disaster. Yet, the real debacles may lie ahead, if these policy measures are employed with a poor sense of cyclical timing.

Today, the only economies in recession are Japan and New Zealand, while Spain is probably in the same boat and Italy, along with the U.K., is looking increasingly precarious. Other economies covered by ECRI are not susceptible to potential shocks, but, with European economic growth in a slowdown phase, there is a risk that the weaker economies will be pushed into new recessions, disastrously aggravating both joblessness and the deficits.

Across the pond, the Fed continues to use metrics like the output gap and core inflation that have historically left it chronically behind the curve. With a far larger balance sheet than it has had anytime in history, there is serious danger that delayed monetary tightening will unleash asset bubbles and/or surging inflation. There is also the risk of an eventual loss of confidence in the fixed income markets, in the absence of credible deficit-reduction efforts.

The only guaranteed cure for long-term unemployment, as well as for youth unemployment, is a long economic expansion, which eventually generates enough demand for labor that employers have no choice but to hire whoever is available. Yet, the real policy risk today is the potential for cyclical timing errors that could end up fostering boom-bust cycles, and therefore result in shorter expansions that doom millions of youth to a lifetime of frustration. ■

