



Needed: A growth strategy for Europe

Written by [Simon Tilford](#), 26 January 2012

The struggle to address the eurozone crisis means that Europe's unprecedented economic malaise is receiving far too little attention. To the extent that the EU has a growth strategy it relies heavily on the adoption of structural reforms in the crisis-hit eurozone economies. But such reforms alone will not drive economic recovery in the short term, however important they could be in the long term. Demand is also crucial, and this requires more expansionary macroeconomic policies. Without them, the European economy faces economic stagnation, which threatens to exacerbate fiscal pressures (especially inside the eurozone), discredit economic reforms, and open the way for a surge in political populism.

There is no doubting the depth of Europe's economic crisis. Output in both the eurozone and the EU is still around 2 per cent lower than before the crisis. Even the supposedly booming German economy grew by only 0.4 per cent between the first quarter of 2008 and the final quarter of 2011 (and hence by less than the 1 per cent managed by the US). The Spanish and UK economies are still almost 4 per cent short of their pre-crisis peaks, the Italian one nearly 5 per cent and Greek and Irish economies anywhere between 10 and 15 per cent. Moreover, both the OECD and the IMF expect the EU economy to stagnate at best in 2012. If a further intensification of the eurozone crisis is avoided – an admittedly big assumption – some member-states may eke out a little growth. But others, such as Spain and Italy, face deep recessions.

The reason for the anaemic economic recovery is the weakness of household consumption and business investment. The latter is still down 14 per cent in the eurozone compared with four years ago, and the picture across the EU as a whole is little different. The dearth of investment is most pronounced in the peripheral eurozone economies plus Italy and the UK, but even the German economy is yet to return to pre-crisis levels of investment spending. Household consumption across the

EU fell less steeply than investment during the recession, but has not yet fully recovered.

In the early stage of the crisis, fiscal policy across the EU was 'counter-cyclical' (that is, most governments spent more in an effort to offset the weakness of consumer spending and business investment). However, policy has since become 'pro-cyclical': cutbacks in public spending are reinforcing the downturn, rather than countering it. Fiscal austerity in the troubled eurozone periphery is now being accompanied by austerity programmes in Britain, France and Italy. Even countries with relatively strong public finances such as Germany – the country's budget deficit fell to just 1 per cent of GDP in 2011 – are tightening fiscal policy. In so doing, European governments are standing conventional macroeconomic thinking on its head. Governments are withdrawing demand from their economies at a time of pronounced private sector weakness.

The fiscal stance is pro-cyclical for three reasons. First, there is continuing disagreement within the eurozone over how to address the currency bloc's sovereign debt and banking crises. The failure to progress towards a proper fiscal union based around debt mutualisation, the absence of a strategy to combat intra-eurozone trade imbalances, and the unwillingness of the ECB to act as a lender of last resort for eurozone governments mean that sovereign borrowing costs within the eurozone have become highly polarised. Germany's borrowing costs are at record lows while other member-states are paying punitively high real interest rates. This, in turn, is compounding the weakness of their public finances, and forcing them to impose ever greater degrees of austerity.

Second, policy across Europe – including in Britain – is being driven by a belief in so-called 'expansionary fiscal consolidation'. This assumes that cuts in public spending will improve household and business confidence and hence boost private consumption and investment. The empirical foundations for such a belief are weak. The pursuit of unprecedented austerity across much of the eurozone has hit household and business confidence hard, depressing economies and contributing to a dramatic rise in public debt. Weak investment has further eroded economies' growth potential, and hence the sustainability of their public finances. In the current circumstances, contractionary fiscal policy has proved to be just that: contractionary.

The third reason why fiscal policy is so pro-cyclical is fear. Governments worry that if they do not cut spending, investors will punish them by shunning their debt. Governments are citing their worsening economic prospects as a reason for further fiscal tightening, which in turn is further weakening their economic prospects. The ratings agencies are right to highlight how self-defeating this is.

Not only is fiscal policy too tight, but monetary conditions remain restrictive, at least across much of the eurozone. Official interest rates are low, but this says little about the availability and cost of capital. Growth in the amount of money circulating in the eurozone economy has stalled and is contracting across the south of the currency union, pointing to a worsening credit crunch. The ECB has resisted pressure to employ unorthodox measures to boost the money supply, such as so-called 'quantitative easing'. This essentially involves central banks 'creating' money by buying assets such as government bonds. The ECB fears the inflationary impact of such measures, despite rapidly ebbing inflation pressures and the growing threat of deflation.

The current macroeconomic policy stance has far-reaching implications for the European economy and political stability. First, by further depressing demand, particularly investment, it is eroding economic growth potential and hence the amount of debt (both public and private) that countries can sustain. Second, it is damaging the political case for structural reforms. Governments will have a tough time maintaining support for reforms if their economies continue to contract and their borrowing costs remain prohibitively high. Third, it provides fertile ground for populism. Mainstream political parties across Europe are pursuing policies that are deepening the economic crisis. A rise of populist political forces would pose a threat to the survival of the eurozone and the cohesion of the EU.