A Long Way From Recovery, Europe Tries to Find Its Way

By LIZ ALDERMAN and ALISON SMALE  AUG. 29, 2014

PARIS — Six years after being struck by economic crisis, Europe is facing a fresh downturn, with few new ideas on the table for reigniting growth and deepening political divisions over the austerity policies that many blame for worsening the malaise.

Even as the United States economy rebounds from its worst recession since the 1930s, Europe is heading in the opposite direction. A halting recovery that took hold in the 18-nation euro currency bloc in the last year has now gone into reverse as Germany, France and Italy, its three largest economies, stumble anew. Some analysts say the region could be headed for another full-scale recession.

Germany, the Continent’s economic engine, contracted in the second three months of the year, while the bloc of 18 European Union nations that use the euro failed to grow at all. Political and financial instability related to Russia’s confrontation with Ukraine and the effects of escalating economic sanctions between Europe and Russia have further clouded the economic outlook.

Unemployment, which in the United States has fallen to 6.2 percent from a peak of 10 percent in 2009, has fallen only marginally in Europe, to 11.5 percent in July from a peak of 12 percent last year, according to figures released on Friday.

“Europe is at risk of secular stagnation,” said Lawrence H. Summers, a former United States Treasury secretary and former economic adviser to President Obama, referring to a situation in which very sluggish economic growth becomes the new norm. Unless governments find a solution, he added, “there is little chance that reasonable and rapid growth is going to return to the eurozone.”

The fresh downturn has worsened tensions between European leaders and Chancellor Angela Merkel of Germany. Ms. Merkel continues to stand by an austerity program that she considers essential to financial stability, but that many critics now say is only deepening Europe’s woes and leaving it at risk of losing a
generation of growth.

The situation has placed additional pressure on Mario Draghi, president of the European Central Bank, to act more aggressively, much as the Federal Reserve has in the United States, to stimulate the economy through bond purchases. In a speech last week at a Federal Reserve conference in Jackson Hole, Wyo. Mr. Draghi for the first time challenged the austerity consensus, suggesting that European governments might need to relax their tight budgets in the short run to give their economies a kick.

Action by the European Central Bank, which meets in Frankfurt next week, has become more urgent in the face of signs of another potential menace: deflation, a downward spiral in prices and wages that could further crimp Europe’s recovery prospects. On Friday, Europe’s statistical agency reported that inflation declined again in August to its lowest level since 2009.

“This is a major red light” for Europe, said Jean-Paul Fitoussi, a professor of economics at the Institut d'Études Politiques de Paris. “We need to change the direction of policy to avoid a situation with potentially worrisome consequences for society and politics.”

It is not clear that a shift in monetary policy alone can reinvigorate the European economies. President François Hollande of France, whose government has been in turmoil after a failed effort by a left-leaning minister to challenge Germany’s economic prescriptions, on Thursday called for a “eurozone summit” to restore growth and investment in the euro area “as soon as possible.”

A new approach is needed, Mr. Hollande told a conference of French ambassadors in Paris, because “the recovery is too weak, because inflation is too low, because the euro is too strong, and because Europe is menaced by long and possibly interminable stagnation if we don’t act.”

Mr. Hollande, a Socialist who as a candidate promised a new economic approach, has shown little willingness to break decisively with Germany over Ms. Merkel’s insistence that keeping government debt under control is the precondition for long-term prosperity.

Still, France, Italy and a number of other countries are likely to press within the European Union in coming months for a loosening of deficit-reduction targets for the next several years.

The austerity program has helped Spain, Ireland and other troubled economies regain their ability to borrow money in the bond markets. But critics say that forcing countries to cut spending and raise taxes to meet fiscal targets
while in recession also delayed and weakened the economic recovery, impeding job creation and income growth.

Ms. Merkel, while agreeing that growth is important, continues to rebuff calls for a change in German policy.

“We can talk about whether you make 2 or 3 percent more debt, or 1 percent, or, like us, a balanced budget,” Ms. Merkel said this week. “But one really must question whether we can go on receiving less than we spend, so that our debts keep on growing. Indeed, a whole crisis of confidence has grown out of that.”

Still, she hinted she could be more flexible if countries undertook reforms to revive competitiveness. Spain, which adopted more business-friendly labor laws and other structural changes to its economy, is one of the few eurozone countries to show signs of recovery. In a visit this week with Prime Minister Mariano Rajoy, Ms. Merkel praised Spain as a model for how to rebound from the crisis.

Ms. Merkel has remained unmoved by her critics, even as Germany’s economy has slowed and been challenged by new pressures like the confrontation with Russia over Ukraine. To some degree, the slowdown in Germany is being driven by a lack of demand for its exports from neighbors like France and Italy, which, lacking the ability to use government spending to spur growth, have struggled to gain economic traction. Italy, the third-largest eurozone economy, has returned to recession and remains saddled with a debt equal to 136 percent of gross domestic product, the highest ratio in the eurozone after Greece. Analysts said a new crisis in Italy could reignite fears that the eurozone will come apart.

Germany is further vulnerable to the strife in Ukraine. Sales of machinery to Russia, the industry’s fifth-largest export market, fell 19 percent in the first six months of the year. On Thursday, Ms. Merkel said the European Union would discuss tougher sanctions this weekend, hours after Kiev accused Moscow of a fresh incursion.

Germany is also grappling with its strained relationship with France, where Mr. Hollande is having trouble holding his party together as calls increase to challenge the supremacy of German economic policy leadership. While the two recessions that have hit France in the last five years have not been as deep as those in other countries, growth has failed to revive meaningfully.

Germans worry about the imbalance between the Continent’s two essential powers, while French leaders feel belittled by Ms. Merkel, who “wants to give us lessons,” said Jean-Christophe Cambadélis, a prominent French Socialist. “We are a great nation trying to pull ourselves together. We are not one of the German...
länder,” he added, using the German word for its 16 states.

“Germany is a strong country, but it is too weak to lead the Continent alone,” said Guntram Wolff, a German who runs the Bruegel organization in Brussels. While trade with France is important, their common projects — monetary union, the European Union itself, centuries of shared history — count for much more, he said.

A prolonged downturn in Europe, should it happen, could weigh on the American recovery and have far-reaching consequences for European society and politics at a time when far-right forces have emerged as challengers in France, the Netherlands, Greece and elsewhere, analysts said.

And as American imperatives point toward more multilateralism, Mr. Summers said, “a greatly diminished and stagnating Europe will mean that the United States will increasingly lack its best partners.”

Liz Alderman reported from Paris and Alison Smale from Berlin. Jack Ewing contributed reporting from Frankfurt.