Behind the Global Growth Slowdown

‘Austerity’ isn’t the problem. Eurozone governments are spending more now as a share of GDP than before the crisis.

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Oct. 14, 2014 7:00 p.m. ET

Global stock markets are falling, and most of the blame is placed on Europe. German factory orders fell 5.7% in August, real GDP is stagnant or falling in many European countries, Standard & Poor’s has downgraded France to AA from AA+, and the International Monetary Fund and the Organization for Economic Co-operation and Development are reducing growth estimates.

All of this is setting off a cascade of fear and pundits are begging governments to "do something." Yet this is not like the panic of 2008, and the slowdown in Europe is not new news; instead it is the "old normal."

Data reported by the European Commission show that the 18 euro area countries had zero real growth in the volume of production during the second quarter of 2014. Euro area real GDP grew only 0.5% in 2013 after falling 1% in 2012. In other words, output was lower in mid-2014 than it was at the end of 2011.

True, the recovery since the Great Recession of 2008-09 has been slow all around, but economic growth in Europe has lagged behind the U.S. for decades. Nonetheless, politicians are still using 2008 as an excuse to grow government even though it is their policies that are causing the slow growth.

We need less government, not more, and yet governments are engaged in deficit spending like they did in the 1970s. It didn’t work then to boost growth, and it isn’t working now. Euro area government spending was 49.8% of GDP in 2013 versus 46.7% in 2006. In other words, euro area governments have co-opted an additional 3.1% of GDP (roughly €300 billion) compared with before the crisis—about the size of the Austrian economy.
France spent 57.1% of GDP in 2013 versus 56.7% in 2009, at the peak of the crisis. This is the opposite of austerity—but the French economy hasn't grown in more than six months. It is no wonder S&P downgraded its debt rating.

Italy, at 50.6% of GDP, is spending more than the euro area average but is contracting faster.

Every economy can be divided into two parts: private and public sectors. The larger the slice taken by the government, the smaller the slice left over for the private sector, which means fewer jobs and a lower standard of living.

If government were more productive than private business this wouldn't be true, but government is not. For example, alternative energy (solar, wind, biofuels) may, might, could possibly, generate cheaper, cleaner, renewable energy in the future. Right now these industries survive because of subsidies. These subsidies are drawn out of revenues extracted from profitable, job-creating industries, which means fewer private jobs, less private investment and less private saving.

Can central-bank policies such as quantitative easing (QE) make up for economic slack, deficits and government waste by force-feeding private business to grow? Consider the judgment of Janet Yellen at a meeting of the Federal Open Market Committee on Dec. 15-16, 2008. Ms. Yellen, then president of the San Francisco Fed, argued that, "As Japan found during its quantitative easing program, increasing the size of the monetary base above levels needed to provide ample liquidity to the banking system had no discernible economic effects."

For quantitative easing to work, it must boost the broader money supply. The Fed's monetary base (currency in circulation and reserve balances) has grown 28.8% per year since QE started. If banks had multiplied this high-powered liquidity, the broader M2 measure of money (all deposits at banks, including money market accounts and cash) would have grown at the same rate. But M2, the measure Milton Friedman told us to watch, has grown just 6.7% per year. If banks had lent most of this new money, M2 and inflation would have accelerated sharply. But excess (unused) reserves are now at $2.7 trillion. This is why inflation has not accelerated.

Keynesians call this a "liquidity trap"—a condition in which consumers will not spend and businesses will not invest. In reality it's the "big government trap"—a condition where the government siphons off the benefits of private growth and investment before they reach the economy as a whole.

The U.S. is growing faster than Europe not because of QE, but because, believe it or not, our government is relatively smaller. Federal, state and local expenditures in the U.S. were 36.5% of GDP in 2013. This is too high, but because it is less than Europe, the U.S. has a larger and more vibrant private sector. The U.S. is leading the world in energy production because of technology such as hydraulic fracturing and horizontal drilling. Meanwhile 3-D printing, the cloud, apps, nano- and biotechnology are being fueled and financed by private business.
Central bankers don't stay up at night writing apps, and U.S. senators don't develop natural-gas plays. Private business creates wealth and the U.S. private sector still leads the world. European growth has been slowing for a long time and is highly unlikely to unfold into a global economic crisis. The stock market decline we are experiencing now is not a prelude to another financial panic.

But it is a signal. Governments are running out of excuses, as they did in the 1970s. The Keynesian, big-government experiment is failing once again, and eventually freer markets will be back in vogue. To think otherwise is to lose hope, and to lose hope is to forget history.

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