The Depth of the Crisis in the Eurozone

Six years after the Great Recession in 2008-2009, the economic conditions of the vast majority of euro area countries remain critical, with recession in many southern European economies and stagnation in the rest. Deflation risk is increasing and unemployment, particularly with youth, is persistently high in the majority of eurozone members. The protracted crisis for the euro area as a whole has become worse than the Great Depression of the 1930s.

The first months of 2014 showed signs of a very modest recovery, but with unchanged policies, growth in the eurozone is likely to remain slow and stagnant. It may be a new normal in Europe that could be extended until, or even after, the end of the decade. In this prolonged stagnation scenario, there are three main risks. First, since levels of public debt will continue to rise as a share of GDP, owing to slow or negative output growth, the issue of public debt restructurings in several peripheral eurozone countries could become very likely. Second, financial market fragmentation will continue to restrain credit and keep the system exposed to financial shocks. Finally, the risk of populist revolts and extremist political forces against EU-driven policies will increase and become permanent.

With reference to the secular stagnation debate about slow growth in advanced countries, the slowdown in observed output growth in the eurozone is mostly due—as explained in this chapter—to gaps between actual and potential output. A large part of this sluggish growth is due to a lack of aggregate demand. This is a function of both the balance sheet recession that almost all euro economies have been facing after the financial crisis and the austerity fiscal policies adopted so far to contrast the former. There are also problems of structural supply-side factors which stem from both the current prolonged recession and the difficult adjustment of many eurozone countries to the new global competitive environment.

Given all this, it becomes even more important for the eurozone to return to potential output as quickly as possible by pursuing policies likely to stimulate economic growth as well. The immediate challenge for the eurozone is thus to engineer a recovery of above-trend growth, especially in the crisis-hit countries, all of which are still well below pre-crisis peak output levels. The "orthodox" handling of the euro crisis by national governments, led by Germany, has greatly contributed to the actual distress. A possible solution is of course not an exit from the euro as proposed today irresponsibly by many Euroskeptics, but one that tries to change and discontinue the policies implemented so far within the eurozone. In this case, the recent rise of populist parties and protest movements in the recent European elections could turn into a positive salutary shock. But the road ahead is indeed very hard.

The Euro is Safer, the European Economy is Not

A few months after the European parliamentary elections that generated a massive protest vote in favor of Euroskeptic and anti-European parties, the economic conditions of many European
countries remains critical. Twenty-seven million are still unemployed, and barely touched by the modest recovery now underway. At the same time, monetary and financial markets have undoubtedly improved in the eurozone by providing greater stability to the single-currency euro. Over the last year and a half, the financial markets have become surprisingly stable and spreads have decreased to pre-crisis levels.

Several developments helped to restore calm but the most notable came from European Central Bank President Mario Draghi who promised to do “whatever it takes” to save the euro. The statement was quickly institutionalized by establishing the ECB’s “outright monetary transactions” program (OMT) to buy distressed Eurozone members’ sovereign bonds. What the system needed to cope with the liquidity crisis in many member countries was a lender of last resort and, even with a two-year delay, the program of the ECB, supported politically by Angela Merkel, provided in fact a lender of last resort operations. Without having spent a single euro so far, the OMT program managed to defeat pervasive panic and convince the markets that the survival of the single currency was no longer at risk, and that no country would have to abandon the euro. Even if the risks of future financial turmoil are not reduced to zero, it is highly likely that we will not come back to the stratospheric spread levels at the beginning of the European crisis.

Following the accommodative monetary policy that was instituted by the major central banks, concerns of a eurozone breakup have receded. The real economy of the eurozone, however, has showed a fragile improvement after more than six quarters of recession. The recovery is slow to occur and, in any case, will be too modest either to boost employment or to exit from the crisis.

If there are no changes, the more realistic scenario is that of a long stagnation of the euro area, even beyond the current decade. This risk refers to both a persistent slower growth of actual output and to a slower potential output growth. The first is the result of a prolonged period of what it is called a “balance sheet recession” made worse by fiscal austerity policies in the eurozone. In addition to long run determinants, potential output growth is also slowing. A declining labor force growth rate and a slowdown in the pace of total factor productivity growth are leading to a gap between actual and potential output, which is in turn linked to short and medium term aggregate demand constraints in Europe. In the eurozone, a prolonged negative output gap has affected potential GDP negatively, mainly by reducing investment. There has also been a continuous deterioration of investment dynamics, particularly in southern European countries, thus penalizing the long run growth perspective.

Hence, in order to find explanations for the current output stagnation and high levels of unemployment in Europe, we should look first at the drivers of aggregate demand and especially investment dynamics. We must take into account, in fact, that European sluggish growth is also the result of a growth model that in many countries—and primarily in Germany—is driven largely by exports and only to a small part by domestic demand. Over the last six years the biggest contribution to growth came from net exports. (Growth of exports outpaced that of imports). In 2008, the Eurozone had a deficit of around €85 billion (less than 1 per cent of GDP); in 2013 it had a surplus of close to 2.5 per cent of GDP.

The Orthodox Approach in Berlin and Brussels

In Brussels, and especially in Berlin, officials continue to be rather optimistic about the future of the eurozone and expect that the current modest recovery may soon turn into a highly stable growth path. They are confident that the adjustment policies adopted so far—a mix of fiscal austerity plus structural reforms—are effectively working and require only more time to be successful. Hence, we’ve seen the proposal of a more flexible application of these policies at country level in order to produce the expected results. France and Spain
were among the first countries to have benefited from this higher margin of flexibility.

But this will not work. There are reasons to believe that the eurozone's orthodox approach even in its more flexible version is not able to offer a viable exit strategy to escape the prolonged debt crisis. One should recall that the orthodox approach is based on three pillars. First, monetary policy should provide the main counter-cyclical support (i.e. demand) at the European level. Second, fiscal policy should be rigidly oriented almost anywhere to fiscal consolidation (according to timing and modalities laid down by the European procedures). Finally, structural reforms would promote the competitive adjustment of the peripheral economies by increasing their labor market flexibility (in output and wage) and growth potential.

But over the past three years this pattern did not find validation in practice. In depressed economies suffering from a liquidity trap, such as in many eurozone countries, monetary policy has lost its ability to provide counter-cyclical support even if short-term interest rates have become close to zero. Meanwhile, the real interest rate (nominal rate net of expected inflation), which ensures those amount of savings and investment needed to achieve full employment, has become negative in many euro countries, due to a sharp fall in aggregate demand. In addition to a powerless monetary policy, fiscal tightening began in 2010-2011 in almost all eurozone countries and proved contractionary, given weak domestic demand. This mix of fiscal retrenchment and lack of monetary stimulus failed to sustain the policies required to support private sector deleveraging and ultimately triggered what turned out to be a long-running crisis, in terms of worsening recession, increasing unemployment, and a deepening spiral of depression.

The austerity programs have not stopped the explosive growth of government debt to GDP ratios; sovereign debt in Greece is still over 170 percent of GDP; in Ireland, Italy and Portugal over 120 percent; and in France and Spain rapidly approaching 100 percent. By deciding that the crisis was due to the fiscal profligacy of the debtor countries, eurozone policy makers ignored the root cause of the crisis in sovereign debt—that it was a financial crisis that generated fiscal consequences—thus confusing the causes with the effects. The contrast with what happened in the U.S. is stark. While from 2011-2012 in Europe economic growth started to slow down and ultimately became negative, in the U.S. the recovery was sustained because expansive fiscal and monetary policies were tightened only gradually. The U.S. has also been relatively successful in deleveraging, with private debt back to the early 2000s levels, relative to GDP, due to more growth and higher repayment levels than those that occurred in most eurozone countries.

A significant change in policies, however, is not given consideration even today by those in charge in Berlin and Brussels. One reason—reiterated at the official level even in the last European Council meeting—is that the performance of the crisis-hit countries has definitely improved, in terms of both strengthening their competitive positions and effective fiscal adjustments. Not surprisingly, because the burden of adjustment has been borne almost exclusively by the most indebted countries in the periphery while creditor countries with large current account surpluses—like Germany—have so far contributed only marginally to the rebalancing of the euro area. This asymmetry has produced, first, a deflationary bias in the eurozone as a whole that has generated a recession-stagnation, particularly in the peripheral countries. Second, it has imposed restructuring processes of the most indebted countries, primarily based on internal devaluations and a type of recovery fully driven by exports.

To be carried out effectively, these adjustment processes taking place in the periphery need adequate time, and need to be expanded to the European level. The present zero-sum-game approaches are very risky for the stability of the euro area. The mechanisms of adjustment are simply that of the old gold standard. Given the very low growth and the inflation of the eurozone at the aggregate level, real adjustment will take place mainly through
deflation in the deficit countries, which is both very painful and raises their debt burdens relative to their GDP.

To cope with such gloomy scenarios the solution is certainly not, as now claimed by many Euroskeptic groups, the exit of one or more countries from the eurozone or the total dismantling of the single currency area. If a country were forced to or encouraged to leave the euro, the consequences for the credibility of the euro could prove devastating. Exit would have large spillover effects on the entire system. The final costs would be dramatic. A more viable therapy is to try to radically change the policy approach that has been pursued thus far.

**What Is to Be Done?**

All in all, a continuation of current economic and policy trends raises serious risks of a Japanese-style stagnation scenario and a fragile sovereign debt sustainability. The vulnerable countries are suffering economic depression and difficulties with debt likely to last many years. The categorical imperative for Europe is to return to a high and stable growth path. Ultimately debt manageability depends on the relationship between the growth of nominal GDP and the interest rate. Only high growth can allow peripheral countries to pursue a strategy of fiscal consolidation and unemployment reduction that is sustainable and effective at the same time.

As mentioned above, sluggish growth of the euro countries today is due to a lack of aggregate demand, which is a function of both the balance sheet recession that almost all euro economies have been facing and the austerity fiscal policies wrongly adopted thus far to combat the former. There are also problems of structural supply-side factors, stemming from both the current prolonged recession and the difficult adjustment of many eurozone countries to the new global competitive environment.

Escaping stagnation requires a balanced policy package involving strong, mutually reinforcing policy interventions that can simultaneously deal with both weak aggregate demand and supply weaknesses. These policies should be implemented at the eurozone level as a whole, rather than at only a national level as has been done in the past. Only from this perspective, can one see a shortage in aggregate demand and a needed change in the combination of fiscal and monetary policies.

In the first part of the coordinated policy package is the European Central Bank’s monetary policy, which should soon launch its own “quantitative easing” and negative interest rates to avert worrying deflationary tendencies. After the measures adopted last June, and facing the slowdown in the already modest recovery, the ECB announced in September this year that it would begin buying packages of loans separated into products known as asset backed securities (ABS) and covered bonds. This will be done to help free up banks’ balance sheets and spur lending, particularly to small and medium-sized enterprises.

In addition to the ECB’s recent measures, President Mario Draghi has previously announced the intention of an open market purchase of public and private bonds, aimed at bringing the size of the ECB balance sheet to 2012 levels. This makes sense. It was an error to let it shrink by approximately 10 percent of eurozone GDP when other central banks were avoiding premature withdrawal of such support. It signals that there is now a clear direction by the ECB toward government bond purchases if the economy and inflation don’t recover.

The measures adopted by the ECB so far, although useful, are unlikely to bring the low inflation in the eurozone to a normal target (close to 2 percent). In the year leading up to July 2014, consumer price inflation in the eurozone fell to 0.4 percent. Moreover, long term inflation expectations, calculated on the basis of financial indicators, had seen a rapid deterioration in the summer of 2014, falling for the first time below the 2 percent threshold. The continuous fall in inflation has increased the risk of a negative trend in prices. If this takes root in agents’ expectations, the trend would be very difficult to reverse.
Given this low inflation environment, the ECB should launch a massive “quantitative easing” of asset purchases. This would buy time for European inflation rates to return to normal and avoid the risk of a debt default by individual countries. It is well known that the transition from a prolonged period of low inflation to a classical deflation is uncommon but leads to a vicious cycle. The deflationary spiral is seen as a process that feeds on itself and is difficult to counteract once triggered. The dramatic experience of Japan confirms this. The eurozone is also, now, probably not too far from a deflationary outcome.

But monetary policy alone is not enough to bring the European economy back to a path of sustainable growth. In a liquidity trap, monetary policy loses traction. Today, in most eurozone economies, stagnant income, high unemployment, and uncertainty about the future, all contribute to the compressing of private spending and demand for credit across the eurozone, while they increase the appetite for liquidity.

It is on fiscal policy that the revival of aggregate demand and, hence, growth in Europe will have to depend. As previously argued in this paper, one should look at the eurozone as a whole rather than simply its constituent parts. There is a strong argument in favor of the coordination of fiscal policies among member states. The overall fiscal stance in the eurozone as a whole is too tight, even though interest rates are at the zero lower bound; the OECD has forecast that the cyclically adjusted fiscal deficit of the eurozone would shrink from a mere 1.4 percent in 2013 to an even more austere 0.9 percent in 2014.

For an expansionary fiscal policy at the eurozone level, symmetrical adjustment mechanisms are needed to impose on both surplus (primarily Germany) and deficit countries. Large trade surpluses remain a powerful pull on economic activity in the eurozone and place large obstacles in the way of needed adjustments between member states especially, when interest rates are close to zero. It follows that a smooth adjustment of intra-euro area macroeconomic imbalances requires a positive-sum-game policy approach in Europe.

Due to German positive net export, the euro area has developed large external surpluses that are exporting deflation to the rest of the world and revaluing the euro exchange rate, thus penalizing the adjustment efforts of peripheral countries. But the German model—that of an open export-driven economy—may not be extended to the entire eurozone. The eurozone is not a small and open economy, but the second largest economy in the world. Additionally, German surpluses have, over the last three years, surpassed on average the 6 percent threshold. These surpluses should be reduced by imposing on Germany, under the Macro-Economic Imbalances Procedure (MIP), a rise in domestic demand to benefit the recovery of the entire euro area. The more Germany and the North expand overall spending, the less difficult it is for the South to carry out necessary adjustments and close the competitiveness gap.

The new European economic governance structure devotes insufficient attention to policies capable of favoring these economic adjustments. The current framework remains weak in parts and incomplete in others. In this regard, over the past years, neither the European Commission nor the European Council, with their expanded jurisdiction and strengthened mandate, were able to put in place procedures and policy instruments that work. They are not details, but key elements that can affect the ability to cope with the current crisis and to offer, throughout Europe and the euro area, a stable path for future growth. New policy and governance priorities are thus required in the eurozone that put more emphasis on cooperation in convergence and competitiveness.

The second important policy intervention is to complete and strengthen the agreement on the European Banking Union (EBU) with its three pillars, namely the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the Single Deposit Guarantee Scheme (SDGS). Financial stability is necessary for the exit from the cri-
The Banking Union could help to rebuild a correctly functioning interbank market, thereby sustaining the economic recovery. As Mario Draghi wrote in a recent intervention “… by mid-2010, most advanced economies were showing signs of returning to growth, albeit at a slow pace. At this point, however, the trajectory of the euro area departed from others. While the recovery gained ground in the U.S., in particular, the euro area entered into a second recession that lasted until the second quarter of 2013. This divergence happened for two reasons that were specific to the euro area. First, the sequencing of policy responses, after the first bail-out for Greece, aggravated concerns about bank and sovereign debt sustainability. Second, these concerns interacted with an incomplete institutional framework in a self-reinforcing way”.

In 2010 and 2011, the euro area followed the reverse policy sequence, compared with that of the United States, by giving precedence to the sovereign debt crisis rather than that of the banks. It was a mistake. The combination of sustained austerity and a credit crunch did enormous structural damage. Many now agree that a fundamental problem remaining for the euro area is to break the perverse relationship between bank and sovereigns and to address the credit crunch that it has generated.

After several years of delays, we are finally addressing the problem of our banks. We know what has been wrong with Europe’s banks. What should be done is clear enough: recapitalize much of the sector and restructure those parts without a viable business model. This should be completed by the banking union which is under construction after the European Parliament and the Council negotiated an agreement on March 2014 to establish this entity.

Progress in the EBU so far has been very significant. There still remain, however, shortcomings related to the common resolution mechanisms, in terms of too complex decision-making for bank resolution and the lack of a fiscal backstop in the interim period.

The most important obstacle that remains is to reach agreement on how the costs, both of injecting capital into failing institutions and of protecting depositors, are to be shared across the euro area. The solutions adopted so far seem more connected with the narrow national interest of northern European creditors, and in particular to the objective of not exposing taxpayers to the risk of having to pay for the mistakes of other member countries. These national selfish interests are a major obstacle for creating a stable and durable economic and financial union. Furthermore, by undermining the role of federal actions they disregard the risks a major financial crisis could have for the euro area as a whole.

The Strategic Role of Medium and Long-term Investments

As previously mentioned in this paper, in order to sustain and consolidate a recovery in the euro area, one must address not only the problems of aggregate demand but also supply-side problems. It is not enough to simply produce more of that which was needed at pre-crisis levels. Firms should instead anticipate production levels that will be profitable for the future. In this regard, substantial productivity advances are needed. These in turn require a more tangibly and intangibly efficient infrastructure, a more highly educated and skilled labor force, and a more productive environment for technological innovation and renewable energies. To achieve these things, structural reforms in individual countries are indeed crucial, but medium- and long-term investments, which are public and private and occur across a range of sectors that could become new areas of growth, are indeed even more significant.

In previous years, reducing public investment has been the main instrument for fiscal consolidation within many countries. In the eurozone as a whole, the fall in private and public investment was almost 17 percent in the period between 2008 and 2013, compared to more than 14 percent in the U.S. in the same period. In almost all eurozone countries,
public investment as a share of public spending decreased dramatically compared to the 1980s and 1990s. While the capital stock grew between 2 and 2.5 percent before the crisis, its growth rate fell below 1 percent thereafter. In Greece, Italy, Portugal, and Spain, the capital stock shrank dramatically.⁶

Quite obviously, this lasting reduction of capital inputs to production must have slowed down the capacities of producing (potential) output. Furthermore, falling investment rates have caused productivity performance rates to deteriorate in all EU countries. They have also reduced the quality of tangible infrastructure networks (in transport and energy) and intangible networks (education, communications, and research spending). These negative trends should be reversed. Countercyclical fiscal interventions through investment should be targeted to these new areas of growth, on the supply side, through public and private investments. To justify these interventions one could use the traditional Keynesian demand argument, emphasizing not only short run demand effects but also the long run growth effects. These interventions would also work through the supply side of the economy. Successful reallocation of labor and capital could increase potential output in conjunction with supply side structural reforms (the creative destruction mechanism outlined by Schumpeter).⁷ The issue of medium- and long-term investments should thus be considered strategic for the future of the euro and the euro area. These are not simply temporary devices but should become a future permanent features of our economies.

These additional investments should be targeted to the European internal market so as to break the bottlenecks to build up effective service networks in Europe. The internal market still has a high potential to be exploited, and should become the new center of gravity for the revival of European domestic demand. As stated above, the eurozone is simply too big an economy for the rest of the world to keep it afloat. In the second quarter of 2014, real domestic demand in the eurozone was 5 percent lower than in the first quarter of 2008. Foreign demand and exports to the rest of the world are not able to compensate for the continuing weakness of European internal demand and the market. Moreover, the European market is simply too big and rich to be supported externally by American and Chinese consumers.

The problem, of course, is finding new financial resources to invest in the medium and long term. But if there is a consistent effort to find them, they can be found. At the European level, the argument for boosting public investment seems to have gathered strength and has been discussed at the last European Council meetings. But the size of the investment plan should be much larger than Jean-Claude Juncker’s so-called plan (about 300 billion euros over three years for the EU as a whole). The magnitude of the effort should be at least twice the size. Action, on this front, that is too timid would be at risk of wasting a potentially good plan.⁸

At the same time, new regulatory frameworks that are friendlier to long-term investment should be explored. In general, there is a need to enlarge the worldwide share of financing for long-term capital investment at the expense of short-termism and speculation. New rules should include accounting standards, prudential principles, corporate governance rules, and ad hoc systems of fiscal incentives. If successful, new financial instruments will be an interesting long-term investment opportunity for private institutional investors, such as pension funds, insurance companies and households.

Investment could be significantly increased at the national level as well. In this regard, one should note, first, that most of this additional investment need not add to net financial liabilities if they are repaid through future revenue.⁹ Budget accounting in the U.S. and Europe fails to distinguish between self-financing capital projects and those financed by general revenues.

One could also think about bilateral negotiations with the Commission to exchange increased space for investment for structural reforms, and through the introduction of a kind of golden rule for individual countries, as many have proposed. In
In this regard, one should define common, detailed guidelines on fiscal accounting and work toward greater cohesion in the eurozone with regards to the nature and quality of public spending vis-à-vis growth.

Furthermore national governments are now able to borrow at interest rates that are historically low—in fact, close to zero or even negative in real terms. If the public sector can create assets that are useful to the economy, it can actually improve its balance sheet and reduce its degree of indebtedness by spending more today. In most advanced economies, infrastructure spending toward lower logistical costs seems to offer obvious opportunities in this direction.

**The Road Ahead is Hard**

The orthodox policies of national governments, led by Germany, to manage the euro crisis have greatly contributed to the actual depressed condition of the eurozone. These policies consisted of fiscal austerity and asymmetrical adjustment with all costs falling on deficit countries, rather than conventional monetary policy and limited recapitalization of banks. As a result, many eurozone countries are trapped in a vicious circle of stagnation and unemployment, from which they have not yet been able to escape. It now looks as though high debt countries might never regain pre-crisis rates of economic growth.

The slowdown in observed output growth in the eurozone is mostly due to gaps between actual and potential output. Given the size of the recessions, economic policy should seek to generate a prolonged period of above-trend growth. Effective policy measures toward the revival of growth and employment should comprise—as pointed out in this paper—a major support to aggregate demand through unconventional monetary policy, a higher symmetry in the macroeconomic adjustment processes, and a strong investment cycle in tangible and intangible assets at the EU and national level. A key role should be assigned to a medium- to long-term approach to restructure our economies and create jobs via massive new investment in infrastructure, upgraded skills, human capital improvements, and low-carbon energy structural policies. Increased long- and medium-term investment would help to stimulate economic activity, growth, and employment and could address long-term problems as well—including inequality in most countries.

We emphasize that these policies should be implemented at the eurozone level, as a whole, rather than within its constituent parts. It is only when one examines the euro that one can identify the deficiencies of current policies.

Only after such a profound policy renewal was implemented, as a way out of the crisis, could a further deepening and revision of the institutional structure of the EU take place. It is not inherently obvious that European governments genuinely want to move in the direction of change and greater cohesion. The mutual distrust between the North and South has increased in the eurozone during these years of crisis.

Thus, the EU is now experiencing a bottleneck. To exit from the crisis, we would need new policies and more integration. But establishing these policies is very difficult today, given the prevalence of national interests. The collective interests of the common institutions are still being pursued too weakly, especially compared to the national interests of the stronger countries such as Germany. The question is whether a viable solution can be found before it is too late. These problems do not just affect the eurozone exclusively as the euro area is the second largest economy in the world. The real risk is that a deepening of the eurozone crisis, if not properly addressed, could turn into a dramatic global crisis.
Endnotes


3. In the case of Italy, for example, trade balances shifted from significant surpluses in the 1990s to increasing deficits in the first decade of the new century.


6. The downturn has hit Italy in particular, severely affecting productivity; the public investment share to GDP fell in 2013 to 17 percent, the lowest since the 1950s. The spending cuts stemming from austerity policy have rocked public investment, with a reduction of one-third in 2010-11.


8. Of course, one should assume that the eurozone countries, unlike what happened in the past, will efficiently use the new investment opportunities. Italy, for example, for over two decades has mostly wasted the opportunity to benefit from the European structural funds. The state of progress for the 2007-2013 EU budget programming period shows that Italy has used just 55 percent of its slice of EU regional funds.