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Europe Needs Pro-Growth Policies, Not Stagnation Sympathy

Reform, not easy money, is the only fix for a slowdown that started before 2008.

By Michael Heise

Almost seven years after the Lehman crash, output in the eurozone has yet to return to 2008 levels, 18 million people are looking for a job, and the outlook is mediocre. Policy makers are under intense pressure to revive the region's economy, yet even diagnosing the problem remains controversial.

Larry Summers and a host of other economists argue that this miserable performance is not only the result of the financial crisis but the symptom of something more profound. In this view, aging populations, low productivity growth and rising inequality have led to a secular shortfall in demand in the world's wealthy economies.

In the eurozone, fiscal tightening has exacerbated this shortfall. To lift economies out of this secular stagnation, the argument runs, real interest rates must be pushed into negative territory. Since this is difficult with nominal rates stuck at zero and inflation turning negative, governments must stimulate growth through debt-financed spending.

This kind of demand management, however, is unlikely to be the solution to Europe's growth problems. The debate about secular stagnation has focused mainly on the fact that since 2008 - economic growth has consistently been below estimated potential output. The bursting of the credit bubble and the ensuing deleveraging have pushed growth below its already weak trend and put downward pressure on inflation. The sovereign-debt crises of 2011-12 have added a massive confidence problem to an already depressed economy.

That much is true. Yet the policy prescriptions from advocates of the secular-stagnation theory aren't convincing. They argue that policy makers can pump up demand by releasing more and cheaper money into the economy through accommodative monetary policy and expansionary fiscal policy financed at ultralow borrowing costs.

Recent experience suggests that's not true. Plunging interest rates in recent years have done little to make firms invest or households consume more. Other factors are holding back demand. Uncertainty plays a major role for consumer and corporate spending alike.

With unemployment stuck at 11% in the eurozone, people are understandably worried about jobs and income and keen to reduce private debt (which still stands at 97% of household incomes). Rather than stimulating demand, today's record-low interest rates add to people's worries by making it difficult to build funds for retirement without incurring scary levels of risk. That's why,

despite stagnating incomes and rock-bottom interest rates, households have not significantly reduced their savings rates.

The picture looks similar on the corporate side. Businesses in the eurozone face an uncertain economic outlook and heightened geopolitical risks as well as huge gaps in corporate pensions that are exacerbated by ultralow interest rates. Lower borrowing costs have done little to whet companies' appetite for borrowing and investing more.

Nor would the recommended fiscal expansion offer many benefits. In many eurozone countries, fiscal policy already looks unsustainable. If governments borrowed even more, households and businesses would expect future tax increases, dampening the incentives to spend and invest. In France, this is already happening.

Rather than stimulating growth, negative real interest rates and higher public debt might encourage consumers and investors to hunker down. A negative feedback loop also can develop. If public borrowing becomes entrenched and monetary measures become blunt, trust in the effectiveness of economic policies will evaporate.

The only option left is to address the root causes of Europe's sluggish growth performance. Europe's trend growth rate has been declining for decades, immune to swings in fiscal and monetary policies. Among the first 15 countries to join the EU, average growth has fallen continuously from 4.3% in the 1960s to 0.4% from 2010-14. The underlying reasons are decelerating population growth and, more importantly, a strong decline in productivity growth.

There is only so much Europe can do about its demographics, at least in the short to medium term. But governments could soften the impact that aging populations and low birth rates will have on growth. They should, for example, seek to raise the share of women and older people in the labor force and enable people of all ages to acquire better qualification.

To turn around Europe's overall productivity performance, governments must improve the investment environment through tax incentives, better regulation and other policies that support innovation. The experience with past crises—from Scandinavia to Latin America and, more recently, Ireland or Lithuania—shows that steady fiscal consolidation, combined with pro-growth reforms, can underpin confidence and gradually restore private demand.

The eurozone has already received plenty of fiscal and monetary stimulus. Now is the time to address the foundations for future growth, from flexible labor markets and well-targeted social security systems to competitive services and a regulatory climate more favorable to investment. Some eurozone countries have already started down this path, either on their own or under bailout agreements, and the positive results are starting to show. For a more positive long-term growth perspective, however, the eurozone still has much work to do. Cheaper money and more debt will not deliver secular growth.

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