# Europe Needs Course Correction


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More than 7 years after the global financial and economic crisis (the Great Recession), the global economy is still struggling to recover robustly. The growth rate remains most fragile in Europe at below 2%. The European Commission judged the economic conditions in Europe as clearly depressed. Worryingly, the International Monetary Fund (IMF), in its October update of the World Economic Outlook, has forecasted growth slowdown in Europe's power house, Germany. Growth is also projected to slow in the UK from 3% in 2014 to 2.5% in 2015 and 2.2% in 2016.

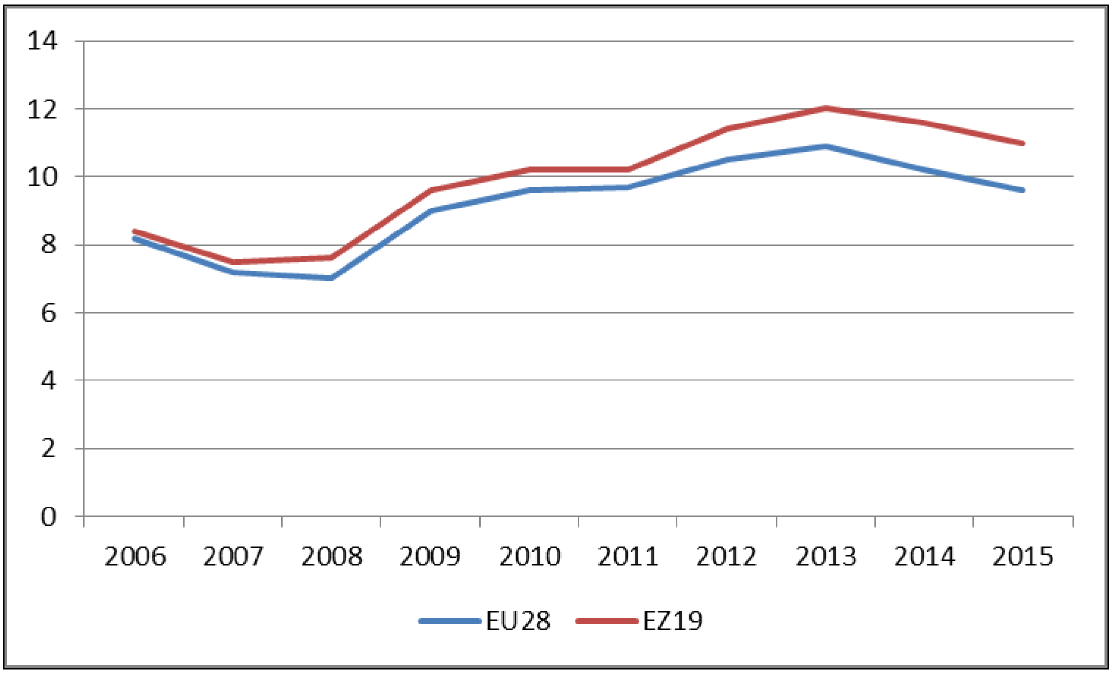
In his October press briefing, Mr. Draghi, the President of the European Central Bank (ECB), stressed the "downside risks" to both economic growth and inflation arising from slowing growth in China and other large developing economies, as well as weak commodity prices. He noted, "the recovery is weak, fragile, uneven, and still is." The Economist, in its 2nd September (2015) issue, has summarized Europe's experience as follows: the "bout of optimism has proved fleeting and there is now increasing doubt about whether the euro area can pull itself out of a rut of low inflation and sluggish growth."

The optimism at the beginning of the year is turning out to be a mirage and failing to boost investor confidence amid continued weak aggregate demand due to policy errors and lack of policy coordination among major economies. The situation is compounded by increasing financial market volatility owing to the failure to address inadequacies of the global economic governance architecture as well as to implement required macro-prudential regulatory measures in major economies. The prospect is appearing bleak because of slowing Chinese economy, falling commodity prices and rising geo-political tensions.

**Persistent high youth and rising long-term unemployment**

The tepid recovery has serious implications for unemployment and poverty. The unemployment rate in the euro area has declined marginally from the 2013 peak of 12%, but it is still unacceptably high and remains well above pre-crisis levels (see Figure 1). According to the latest Eurostat estimates, 22.631 million men and women in the EU-28, of whom 7.323 million were in the euro area (EA-19), were unemployed in September 2015. Only in the US, consistent with sustained recovery, the unemployment rate continues to decline from the peak of nearly 10% at the height of the crisis in 2009; now it stands at around 5%.

**Figure 1: Europe's unemployment woes continue**




Source: Eurostat

Young persons (under 25) are the worst affected segment of the labour force. The youth unemployment rate has increased faster than the adult unemployment rate since the global financial crisis began in 2008. At the end of June 2014, more than 2 in 10 young workers were unemployed compared with 1 in 10 adult workers. This rapid rise in youth unemployment cannot simply be attributed to structural factors, such as high minimum wages or skills mismatch.

The Great Recession reversed the declining youth unemployment rate between 2005 and 2007; from the second quarter of 2008, the youth unemployment rate took an upward trend peaking at 23.8 % in the first quarter 2013. In September 2015, 4.540 million youth were unemployed in the EU-28, of whom 3.113 million were in the euro area. High youth unemployment is not just a problem of Southern European countries. With youth unemployment rate in excess of 20%, it is also a challenge for countries like Belgium, Ireland, France, Finland, Sweden and Luxembourg.

High youth unemployment is associated with deterioration of mental health as well as crime; it represents a lost or scarred generation. The experience of early job loss can "scar", lowering their chances of finding gainful employment with a decent wage in the future. These effects can persist for longer than a decade, affecting generations of workers.

This is a real possibility as long-term unemployment in Europe has also swelled. About half of Europe's unemployed have been jobless over a year. More than 12% of them have not worked for over four years. The situation is more acute in Southern Europe; more than 60% of jobless Italians have not worked in over a year; in Greece the rate is over 70%.

Long-term joblessness in some new EU member states of Eastern Europe persisted despite economic recoveries. For instance, in Slovakia, the long-term unemployed grew to nearly 75% of overall unemployment, as workers who had lost their jobs in the bad years were not rehired when economic conditions improved.

Thus, long-term unemployment can render itself self-perpetuating as skills are forgotten, confidence drains and the risk of poor health increases. This limits the economy's ability to grow its way out of a recession; recessions end up lasting longer because of a less productive workforce. High youth unemployment can make the social security or pension system less sustainable, as the burden of supporting a growing number of retired workers falls on fewer and fewer younger workers.

Besides the rising poverty level that these cause, high youth unemployment can adversely affect social cohesion, making progress with greatly needed difficult reforms even harder. There is an added problem of the tide of refugees from conflict areas. Long-term, especially youth, unemployment and a refugee influx in large numbers can be an explosive mix that can rip through the social fabric and create political instability.

In other words, economic woes feed into political ones. Unemployed people are more likely to distrust their politicians; they may lose faith in the current political system or arrangement. This can strengthen the hand of populist politicians who can blame refugees and other vulnerable minority groups for a nation's economic and social woes. Thus, it is in the interest of all to solve the problem of persistent high unemployment, especially of youth.

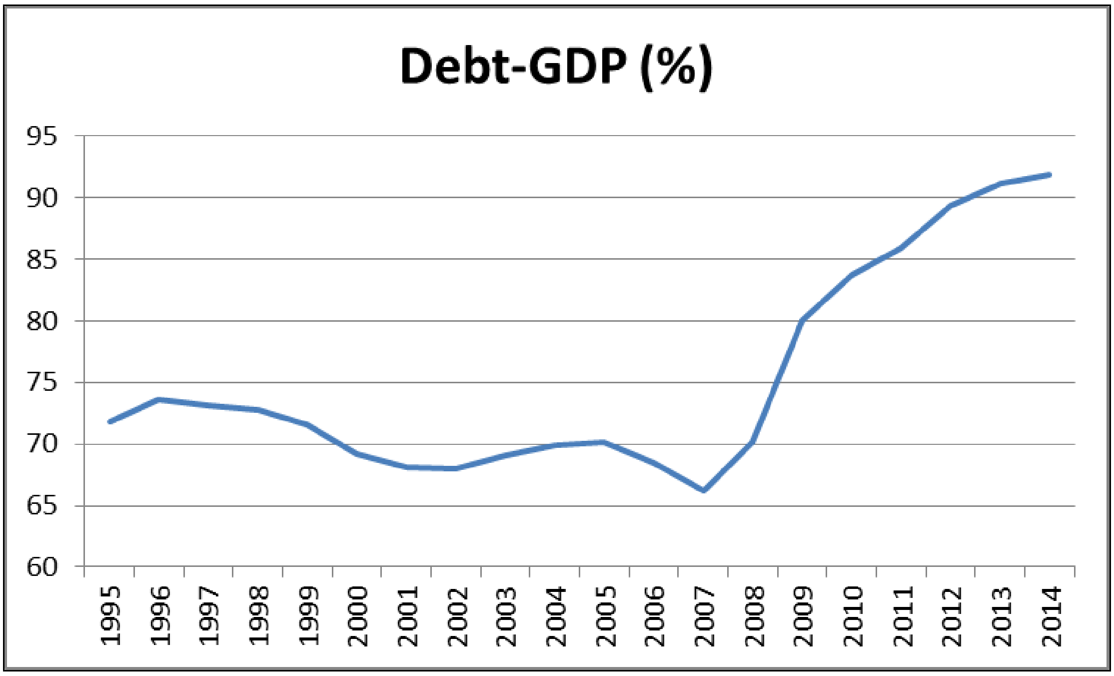
**Course correction required**

The European policy makers are focusing on debts and deficits, not unemployment and slow growth. This is based on the belief that fiscal consolidation would generate enough investor confidence to offset the contractionary impact of public expenditure cuts. Private investment and expenditure should also get an inducement from lower (near zero) interest rate engendered through unconventional monetary policy or quantitative easing of the ECB. While that is the demand side story, the European policy makers are also concentrating on structural reforms to deal with the supply side. The European Commission has adopted 'fiscal responsibility' as a key pillar of its stability and growth strategy, together with boosting investment and a renewed commitment to structural reforms.

The United Nations has been consistent in arguing against pre-mature withdrawal of stimulus packages and fiscal consolidation. Clearly, the policy-mix of structural reforms and fiscal consolidation is not working. In a number of voxeu postings we have criticized the basis of this policy stance, i.e., expansionary fiscal austerity. We have also cautioned against pre-mature fiscal consolidation at the first sight of green shoots of recovery.

Despite focusing on fiscal consolidation and severe cuts in public services, debt levels in European countries remain high (see Figure 2). The debt-GDP ratio, in fact, increased not only in Greece which has been in the news for a while, but also in other countries, such as Italy, Portugal, Belgium, Spain, France and the UK. Continued low growth is making debt-reduction strategy and fiscal consolidation self-defeating. Government debt in the Euro zone reached nearly 92% of GDP at the end of 2014 - the highest level since the single currency was introduced in 1999. It was only 66.2% of GDP in 2007.

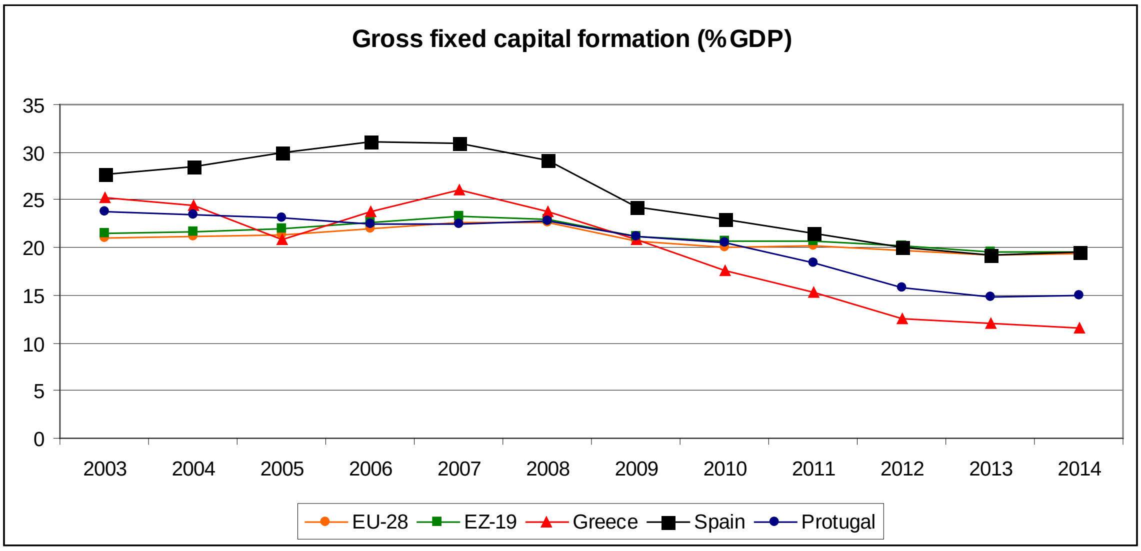
**Figure 2: Euro zone's debt has hit record high**




Source: Eurostat (updated annually on December 31st)

In its latest World Economic Outlook (October 2015), the IMF has identified a vicious circle affecting global growth and recovery. Low aggregate demand is a discouraging factor for investment; slow expected potential growth itself dampens aggregate demand, further limiting investment. Gross fixed capital formation in Europe, especially crisis-ridden economies, has collapsed precipitously (see Figure 3). This is despite a very low interest rate environment. IMF has also noted that prolonged recessions may have a permanent negative effect not only on trend productivity levels, but also on trend productivity growth, as well as on wage growth that in turn feeds into low aggregate demand.

**Figure3: Investment collapses in Europe**




Source: Eurostat

Extra-ordinary buying of government bonds or quantitative easing of the ECB has not only failed to boost investment, it is also unable to thwart a deflationary threat in the Euro zone.

Consumer prices in the Euro zone fell 0.1% in September 2015 from a year ago. The European recovery is too weak to reduce very high levels of unemployment and government and household debt. That has created large amounts of spare capacity, which is not only discouraging investment and causing declines in potential output growth, but also putting downward pressure on prices.

**Fiscal policy needs to play a more active role**

While the policy makers have opted for long-run fiscal adjustment in light of higher than ever stock of public debt, doubts about the subdued recovery calls for slowing fiscal consolidation and providing short-term stimulus. This is reflected in the European Commission's emphasis regarding 'fiscal responsibility' that Member States "still need to secure long term control over deficit and debt levels" while underscoring that consolidation should be "growth-friendly". Based on the analysis of country budgetary plans for 2015, the Commission has assessed the overall fiscal stance in the Euro area as a whole broadly neutral. However, it judged country-level distribution of fiscal policies as sub-optimal, as "some Member States are called to increase their efforts to comply with the Stability and Growth Pact (SGP), [which] implies a degree of fiscal support coming from the exploitation of the fiscal space available elsewhere".

If there is any lesson that can be drawn from a better recovery and job growth in the US, the European policy makers need to eschew fiscal consolidation and allow fiscal policy to play a more supportive role. IMF in its October 2014 World Economic Outlook advised in favour of an infrastructure push considering low borrowing costs and weak aggregate demand. It also observed that "debt-financed projects could have large output effects without increasing the debt-to-GDP ratio, if clearly identified infrastructure needs are met through efficient investment".

We find high correlation between public investment and gross capital formation: 0.542 in EZ-19, 0.840 in Greece, 0.711 in Spain and 0.751 in Portugal, during 2003-2014. It is imperative that public investment needs to expand in growth and employment creating infrastructure, green technology, renewable and clean energy, and other areas that enhance sustainability – economic, social and environment.

**'Golden' and 'Silver' rules of public investment**

IMF's suggestion for debt-financed public investment is in line with what some authors have called 'Golden' and 'Silver' rules of public investment. The golden rule argues that future generations should contribute to financing public infrastructure investments via the debt service as public investment increases the public capital stock and creates growth for the benefit of future generations. Therefore, debt-financed public investment promotes intergenerational fairness as well as economic growth. Failure to allow debt financing is likely to lead to under-provision of public investment due to a disproportionate burden on the current generation.

Achim Truger believes that "such a golden rule of public investment could even be approximated for some time without any changes in the current institutional framework, if Commission and Council were willing to use the interpretational leeway within this very framework." But a change in the framework would be needed to firmly anchor the golden rule. This could be done as an 'Investment Protocol' under the simplified revisions procedure of Article 48 of the Lisbon Treaty.

Meanwhile the 'silver' rule can be applied to provide the urgently needed boost to the European economy in the short term similar to the 2008 European Economic Recovery Programme during the Great Recession to rebuild social capital, such as investment in education, healthcare with a view to achieving the neglected Europe 2020 goals pertaining social inclusion or other areas that have suffered severely from austerity over recent years. Such spending has become urgent with the influx of refugees.

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2 European Commission (2015), "European Economic Forecast Winter 2015", *European Economy*, N°1/2015.

3 See for example, UN's flagship publication, *World Economic Situation and Prospects*, 2010, 2011, 2012. Concerns were also expressed in the publications of the UN Regional Commissions, UNCTAD (*Trade and Investment Report*) and ILO.

4 "Growth and jobs in Europe: Which way now?", 20 November 2014 http://www.voxeu.org/debates/commentaries/growth-and-jobs-europe-which-way-now; "Revisiting the evidence on expansionary fiscal austerity: Alesina's hour?", 28 February, 2012, http://www.voxeu.org/debates/commentaries/revisiting-evidence-expansionary-fiscal-austerity-alesina-s-hour; "Latvia: Going beyond the fiscal austerity debate", 27 June, 2012, http://www.voxeu.org/index.php?q=node/8169; "Fiscal austerity and the youth employment crisis", 1 June, 2012, http://www.voxeu.org/index.php?q=node/8063; "Fiscal consolidation, growth and employment: what do we know? ", 21 June, 2010, http://www.voxeu.org/index.php?q=node/5216; "The fallacy of austerity-based fiscal consolidation", 2 August, 2010, http://www.voxeu.org/index.php?q=node/5312;

5 "The G8 Finance Ministers and the 'Green Shoots' of Recovery: The Pitfalls and Perils of a Premature Exit Strategy", 18 June, 2009, http://www.voxeu.org/index.php?q=node/3670

6 European Commission (2014a), "Annual growth survey 2015, Communication from the Commission", COM (2014) 902, 28 November.
European Commission (2014b), "2015 draft budgetary plans: overall assessment, Communication from the Commission", COM (2014) 907, 28 November.

7 IMF, *World Economic Outlook*, October 2014, p. 75. In a recent working paper, IMF, based on a study of 17 OECD countries, covering the period since 1985, concluded, "increased public investment raises output, both in the short term and in the long term, crowds in private investment, and reduces unemployment. Several factors shape the macroeconomic effects of public investment. When there is economic slack and monetary accommodation, demand effects are stronger, and the public-debt-to-GDP ratio may actually decline. Public investment is also more effective in boosting output in countries with higher public investment efficiency and when it is financed by issuing debt." Abiad, Abdul, Davide Furceri and Petia Topalova (2015). "The Macroeconomic Effects of Public Investment: Evidence from Advanced Economies", *IMF Working Paper*, WP/15/95, May 2015,

8 See for example, Truger, Achim (2015), "Reviving EU Fiscal Policy: 10 Ways To Strengthen Public Investment", *Social Europe,* 9 March, http://www.socialeurope.eu/2015/03/public-investment-2/