CENTRE FOR EUROPEAN REFORM

Why has the eurozone's recovery been weaker than the US's?

by Philip Whyte

The eurozone and the US were never going to enjoy strong, 'V-shaped' recoveries after 2009. The reason lies in the nature and scale of the shock that they suffered. History suggests that recessions caused by financial crises are unusually severe, and that recoveries from them are more sluggish than those which follow more run-of-the-mill downturns. Its transatlantic scale, moreover, made the shock exceptionally large. It is no surprise, then, that the US and the eurozone have experienced weaker recoveries than normal since 2009. What is surprising, and does need explaining, is why, five years after being hit by a largely common shock, the eurozone's recovery has been so much weaker than the US's.

Consider the contrasting positions in which the US and the eurozone now find themselves. At the end of March 2013, GDP was 3.2 per cent above pre-crisis levels in the US, but 3.2 per cent below them in the eurozone. (Relative to pre-crisis levels, US output was also higher than in Germany, the eurozone's best performer since 2009.) In the US, the unemployment rate has dipped below 8 per cent, whereas in the eurozone it has edged up above 12 per cent (and higher in Southern Europe). These divergent positions are mirrored in the fiscal and trade accounts. The eurozone's structural budget deficit is small compared with the US's; and in contrast to the US, the eurozone now runs surpluses on its trade and current accounts.

What explains these very different outcomes? The obvious answer is that policy diverged. But why did it do so? It is tempting to look at the respective points of arrival and conclude that these just reflected different preferences on the two sides of the Atlantic. The US chose to support growth and employment, while the eurozone opted to focus on adjustment (by consolidating public finances and promoting external 'competitiveness'). The trouble with this story is two-fold. First, it is far from clear that Americans have a stronger attachment to John Maynard Keynes than do Europeans. Second, economic policy on the two sides of the Atlantic was relatively well aligned in 2009 and only started to diverge in 2010.

In late 2008, the policy consensus in the G20 was to avoid repeating the mistakes of the 1930s. This meant throwing both Keynes and Milton Friedman at the crisis in hand (a policy mix briefly supported by Germany and the

Bush administration). Central banks were to slash official interest rates and provide liquidity support to the banking system. Governments, meanwhile, were to make sure that credit institutions were recapitalised (with taxpayer funds if necessary) and provide a fiscal stimulus to support demand. Broadly speaking, this is what actually happened. The main difference between the US and the eurozone in 2009 is that Europeans showed less urgency than the Americans in repairing their banks.

The event that broke the 2008 policy consensus was the Greek sovereign debt crisis in late 2009. Greece did two things: it weakened nerves and confused thinking. Governments with high ratios of public debt to GDP suddenly feared that they would suffer crippling increases in borrowing costs if they did not immediately turn to fiscal austerity. And Europeans persuaded themselves that tightening fiscal policy would boost confidence and private-sector spending, even in countries where businesses and households were highly indebted and busy deleveraging. During 2010, then, budget deficits came to be seen by many as the cause, rather than the consequence, of financial crises and weak economic growth.

This was the point at which macroeconomic policy on the two sides of the Atlantic started to diverge. In truth, both sides turned less Keynesian during 2010. The eurozone, however, did so with greater gusto. Across Europe, government spending was cut and taxes were raised. By 2012, the eurozone was running a structural budget deficit of just 1.6 per cent of GDP, its smallest since 2000 and down from 5.1 per cent in 2009. (By contrast, the US was still running a structural deficit of 7 per cent of GDP, compared with 10.2 per cent in 2009). The downside to synchronised fiscal tightening across Europe was its impact on output: economies contracted broadly in proportion to the amount of austerity adopted.

The reason fiscal tightening had such a detrimental impact on output is that it was not offset by conventional monetary easing. The point is not just that the European Central Bank (ECB) was more inflation-obsessed than the US Federal Reserve – although it was (the ECB even raised its key refinancing rate in July 2011). It is that even if the ECB had been less conservative, interest rates were already low and had little scope to fall much further. To make matters worse, weaknesses in the banking system and flaws in the eurozone's design impaired the ECB's monetary policy transmission mechanism: bank lending rates remain much higher in countries like Spain, where activity is particularly weak, than in Germany.

Did Europeans have any alternative but to turn to austerity in 2010? The evidence suggests that they did. Japan, which has the world's highest ratio of public debt to GDP, has long had its lowest borrowing costs. The reason Spain faced higher borrowing costs than Britain in 2010-11 was not its fiscal position (which was slightly better), but the nature of the central bank that stood behind it. Once the ECB overcame its public reluctance to act as lender of last resort to governments in August 2012, yields in Spain fell (even as the ratio of public debt to GDP rose further). The decline in yields since mid-2012 is not explained by austerity: if it were, President Hollande would be more of a fiscal hawk than Sarkozy.

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The reason the eurozone has experienced a weaker recovery than the US is that it has made more glaring mistakes. Many eurozone countries were slower than the US to repair their banks (perhaps because they gambled that recovery was imminent and that banks would soon be restored to profitability). Sickly banks have weighed heavily on the eurozone, where firms are more reliant on bank funding than in the US. Fiscal policy was less expansionary in the eurozone than in the US in 2009, and was tightened more sharply thereafter. And for a variety of reasons – political, institutional and other – the ECB has turned out to be a more cautious central bank than the US Federal Reserve, with sometimes unfortunate consequences.

Europeans might object that they are further down the path of 'adjustment'. Unlike spendthrift Americans, they are running smaller budget deficits and have restored their 'external competitiveness'. But this argument is hard to sustain. The truth is that the eurozone has paid a high price in terms of output and employment, and that some of this pain was probably unnecessary. Despite two years of fiscal austerity, the eurozone's ratio of public debt to GDP has still risen sharply (because GDP, the denominator, has contracted). And while the eurozone is now running a current-account surplus and the US a deficit, this has much to do with the fact that demand has been growing in the US but falling in the eurozone.

Philip Whyte
Senior research fellow, CER