CENTRE FOR EUROPEAN REFORM

The eurozone economy needs a kick-start

by Christian Odendahl & Simon Tilford

With Greek banks raising €8.5 billion worth of equity from investors, Italian government bond yields touching all-time lows, and the German economy growing at an annualised 3.3 per cent in the first quarter of 2014, the eurozone appears to have finally overcome the crisis. Despite such positive news, there is ample reason for caution about the outlook for the currency union. Unless eurozone policy-makers do more to bolster demand and target structural reforms on product as well as labour markets, optimism is likely to prove short-lived.

Eurozone optimists usually base their case on a subset of the following seven arguments. First, the world economy is bound to grow faster: the IMF estimates that world growth will be 3.6 per cent in 2014, up from 3 per cent in 2013. This should raise demand for European exporters.

Second, confidence is returning to businesses and consumers in Europe. According to survey evidence both are above their long-term averages, with consumer confidence back at 2006 levels.

Third, prices and wages in southern economies have fallen relative to those in the eurozone 'core', compensating for some of the exuberance before the crisis and slowly making firms and workers competitive on European and world markets.

Fourth, reforms to the structure and institutions of some eurozone economies will have a positive impact on economic growth. For example, most countries have improved their rankings in the World Bank's Ease of Doing Business Index, and labour markets have become more flexible, according to the OECD.

Fifth, after years of low investment and consumption, consumer goods (for example, cars and fridges) and machinery equipment need replacing. This pent-up demand will give impetus to the eurozone economy.

Sixth, the largest economy, Germany, is on course to grow robustly. With record employment, relatively low debt levels and long anticipated increases in real wages, domestic demand will help to rebalance the eurozone economy, and push up German prices and wages compared to those in periphery countries.

Finally, the eurozone financial sector is being repaired. The ECB is currently inspecting the banks' balance sheets, forcing them to realise losses and raise capital. This will make room for new loans to businesses, softening the credit crunch in the most affected countries such as Italy and Greece and allowing for new investment. A common rule book for future bank rescues should also reduce uncertainty around European banks by making plain what bank investors have to lose in case of a crisis.

Unfortunately, these seven reasons for optimism are matched by just as many reasons for pessimism about the outlook for the eurozone. First, a growing world economy is certainly a welcome source of demand for European producers. But the rising export dependence of the eurozone means that any hiccup in the world economy – perhaps as a result of a sharp slowdown in China – will have stronger effects on the eurozone recovery than if the recovery were more balanced.

Second, while overall confidence is improving, it is volatile and uneven: consumer confidence, for example, is weak in France but high in Germany, and Italian firms' optimism is muted. What is more, hard data are following such survey evidence less closely than in the past – positive sentiment might not be a precursor to stronger consumption and investment.

Third, the adjustment in relative prices and wages is being undertaken under the pressure of very high unemployment. Since jobless workers and those suffering pay freezes are unlikely to consume more, such adjustment has negative side-effects which in the short run exceed the gains from increased export competitiveness. Moreover, persistently high unemployment continues to erode skills and therefore productivity.

Fourth, the structural reforms have so far focussed on labour market liberalisation rather than opening up product markets, which are more important for productivity gains. The 'competitiveness' of a country, properly defined, is not just about relative price competition but about investment, innovation and genuine productivity growth. If the eurozone continues to focus on 'price competitiveness' rather than productivity gains, the recovery will remain anaemic: wage cuts hurt demand, while lack of investment and loss of skills damage growth potential.

Fifth, inflation is very low across the eurozone but especially so in countries that are most in trouble. This makes real interest rates – interest rates corrected for inflation – highest in Italy, Spain and Greece, and lowest in Germany and Austria, which is the opposite of what is needed. Such inverted real interest rates are a natural feature of a monetary union, but hold back the needed recovery in investment in the depressed economies. Low inflation also makes it harder to reduce debt burdens (both private and public), thus extending the period in which households and firms cut back on spending, in turn hurting demand and the economy.

Sixth, the German economy is currently strong but unlikely to grow fast enough to provide the demand stimulus needed in southern Europe. The good first quarter was an outlier reflecting the impact of a mild winter. Investment is held back by a lack of competition in many service sectors, uncertainty about energy prices and weak public spending on infrastructure. Another problem is that German exporters are reluctant to raise wages as a lack of demand from Europe is hurting their business; and German consumers are only slowly becoming more confident about spending.

Finally, the financial sector is still fragmented along national borders, despite progress on the banking union. Since further institutional progress is unlikely, this fragmentation will persist and make divergent real interest rates worse: Italian banks and companies will still have to pay more to investors for the mere fact of being in Italy.

In summary, the positive trends in borrowing costs and consumer and business confidence have not so far been reflected in hard data: the eurozone economy is barely growing, unemployment remains near record levels and deflationary pressures are strong. The reason is that most economies suffer from a lack of demand: households and governments are cutting back spending, firms are hardly investing and the world will only buy so much of what Europe produces. At the same time, Germany will not grow fast enough to help its eurozone peers out of their malaise.

If the eurozone is to grow as strongly as it should, given the depth of the slump, policy-makers need to do more to support demand. The ECB should deploy all available tools aggressively to lift the expectations of consumers and investors, and weaken the euro. Fiscal policy should be supportive of growth, particularly in countries that can easily afford it, like Germany – which needs to invest more in research, education and infrastructure for its own sake. Finally, structural reforms need to be targeted at boosting competition in product markets and productivity, not just at lowering wages. This entails taking on powerful vested interests in the service sector, especially the professions. Unfortunately, progress on all three fronts is slow, despite the ECB's latest efforts suggesting that much of the current euro optimism is misplaced.

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