Who Lost Europe?

BY DANI RODRIK

The future of the European Union and the fate of the eurozone hang in the balance.

Financial meltdown has been averted in Europe—for now. But the future of the European Union and the fate of the eurozone still hang in the balance. If Europe doesn't find a way to reactivate the continent's economy soon, it will be doomed to years of gloom and endless mutual recrimination about "who sabotaged the European project."

Having suffered a deeper economic collapse in 2009 than the United States did, Europe's economy is poised for a much more sluggish recovery—if one can call it that. The International Monetary Fund expects the eurozone to expand by only 1 percent this year and 1.5 percent in 2011, compared to 3.1 percent and 2.6 percent for the United States. Even Japan, in a deep slump since the 1990s, is expected to grow faster than Europe.

European growth is constrained by debt problems and continued concerns about the solvency of Greece and other highly indebted EU members. As the private sector deleverages and attempts to rebuild its balance sheets, consumption and investment demand have collapsed, bringing output down with them. European leaders have so far offered no solution to the growth conundrum other than belt tightening.

The reasoning seems to be that growth requires market confidence, which in turn requires fiscal retrenchment. As Angela Merkel puts it, "growth can't come at the price of high state budget deficits."

But trying to redress budget deficits in the midst of a collapse in domestic demand makes problems worse, not better. A shrinking economy makes private and public debt look less sustainable, which does nothing for market confidence.

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In fact, it sets in motion a vicious cycle. The poorer an economy's growth prospects, the larger the fiscal correction and deleveraging needed to convince markets of underlying solvency. But the greater the fiscal correction and private-sector deleveraging, the worse growth prospects become. The best way to get rid of debt (short of default) is to grow out of it.

So Europe needs a short-term growth strategy to supplement its financial support package and its plans for fiscal consolidation. The greatest obstacle to implementing such a strategy is the EU's largest economy and its putative leader: Germany.

Even though its fiscal and external accounts are strong, Germany has resisted calls for boosting its domestic demand further. Its fiscal policy has been expansionary, but nowhere near the level of the United States. Germany's structural fiscal deficit has increased by 3.8 percentage points of GDP since 2007, compared to 6.1 percentage points in the United States.

What makes this perverse is that Germany runs a huge current account surplus. Projected to amount to 5.5 percent of GDP in 2010, this surplus is not far behind China's 6.2 percent. So Germany has to thank deficit countries like the United States, or Spain and Greece in Europe, for propping up its industries and preventing its unemployment rate from rising further. For a wealthy economy that is supposed to contribute to global economic stability, Germany is not only failing to do its fair share, but is free-riding on other countries' economies.

It is Germany's partners in the eurozone, especially badly hit countries like Greece and Spain, that bear the brunt of the costs. These countries' combined current account deficit matches Germany's surplus almost exactly. (The eurozone's aggregate current account with the rest of the world is balanced.)

The traditional remedy for countries caught in the kind of crisis that Spain, Greece, Portugal, and Ireland find themselves in is to combine fiscal retrenchment with currency depreciation. The latter gives the economy a quick shot of competitiveness, improves the external balance, and reduces the output loss and unemployment that accompany fiscal cutbacks. But eurozone membership deprives these countries of this powerful tool, and depreciation of the euro itself is of limited benefit since so much of their trade (around 50 percent) is with Germany and other eurozone members.

There are few other tools at hand. There is the usual call from international organizations and some economists for "structural reforms," which in this context largely means increasing firms' ability to fire workers. Whatever long-term benefits such reforms might bring, it is difficult to see how they would provide immediate benefits. Reducing the cost of firing workers will not increase demand for labor much when no one wants to hire new workers.

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Short of dropping out of the eurozone, the only real option available to Greece, Spain, and the others to boost competitiveness is to engineer a one-time across-the-board reduction in nominal wages and prices for utilities and services. This is a difficult task under the most favorable circumstances. The European Central Bank's low inflation target (2 percent) renders it virtually impossible, as it implies requisite downward adjustment in wages and prices of 10 percent or more.

So Germany's refusal to boost domestic demand and reduce its external surplus, along with its insistence on conservative inflation targets for the ECB, severely undercuts prospects for European prosperity and unity. It virtually guarantees that Greece, Spain, and others with large private and public debts will be condemned to years of economic decline and high unemployment. At some point, these countries may well choose to default on their external obligations rather than endure the pain.

Germany's leaders may take comfort in lecturing other governments about their profligacy. And it is true that some, like the Greek government, ran too-high deficits during the good times and endangered their future. But what about Spain or Ireland, where the borrowers were not the government but the private sector? If others borrowed too much, doesn't it follow that Germans lent excessively?

If Germany wants the rest of Europe to swallow the bitter pill of fiscal retrenchment, it will eventually have to recognize the implicit *quid pro quo.* It must pledge to boost domestic expenditures, reduce its external surplus, and accept an increase in the ECB's inflation target. The sooner Germany fulfills its side of the bargain, the better it will be for everyone. ◆