Europe five years into crisis: investment not austerity as the way out

Introduction

Economic performance across the EU from 2008 to 2013 has been poor in comparison with previous decades and with much of the rest of the world. Overall, GDP levels were lower at the end than at the beginning of the period. There has been little move towards more modern and innovative economies. No new base has been laid for greater international competitiveness in the future and economic stagnation has been accompanied by widening divergences between countries.

Part of the explanation for the exceptionally poor performance of EU member states lies in past development, but the central explanation set out in what follows is the wrong choice of policies. The EU was not designed to take rapid action, but the first steps were moving in the right direction. It advocated economic stimulus measures, with public spending replacing the falling private-sector activity.

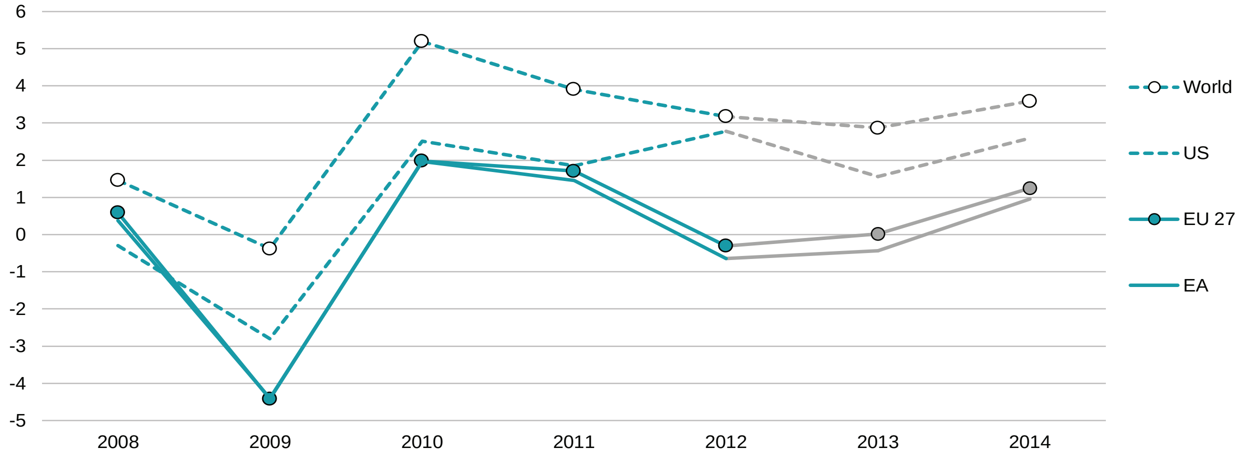
From 2010 the EU emphasis shifted. The crisis had previously appeared considerably less severe within the eurozone than outside it. Difficulties with Greece's public debt changed this. Rather than finding an effective solution, the EU favoured conditional help, with conditions that blocked sustained recovery.

Failure to resolve Greece's crisis led to a loss of investor confidence in a further series of eurozone countries, all previously judged secure. The widening of austerity in turn depressed economic activity, particularly within the eurozone while those outside have begun to perform slightly better. As the following sections demonstrate, the imposition of tough rules, justified as a means to restore confidence so that a future crisis would be avoided, has neither resolved the current crises nor put the EU back on the road to economic growth and modernisation.

Topics

Economic developments: struggling with stagnation

Figure 1.1 Real GDP growth (at 2005 market prices), EU27, EA, US, World, 2008-2014



Source: Own calculations using IMF data.
Note: 2013-2014 are forecasts.

A double-dip recession

Figure 1.1 shows the growth rates for the EU and eurozone compared with the USA and the world as a whole over the period from 2008, when the financial crisis spread beyond the banking sector in the USA, to 2013. Much of the world, largely unaffected by the previous excesses of the banking system, weathered the crisis with only a slight drop in growth rates. The EU too showed recovery after 2009, helped by continued public spending to counter the falling activity from the private sector. However, as Figure 1.1 shows, the EU diverged from the USA and the rest of the world from 2010, falling back into depression.

As is shown in the sections that follow, the second depression followed policy changes within the EU. It has slowed growth in the rest of the world by reducing demand for imports from China and other rapidly developing countries. Nevertheless, annual growth rates in developing Asian countries were still above 6% in 2013, compared with the small decline in the EU.

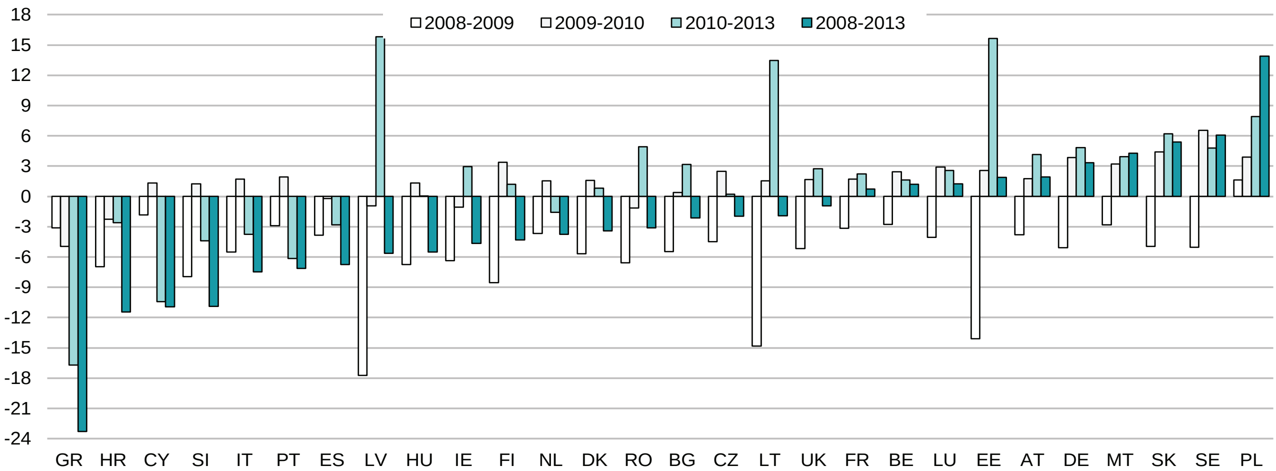
This second depression, although fully predictable in the context of policies pursued, was not foreseen by the European Commission. Its autumn forecast of 2010 claimed that 'the economic recovery in the European Union and the euro area is making progress' (European Commission 2010: vii). It predicted 2% growth by 2012. In spring 2012 the forecast, by then acknowledging stagnation for that year, was for recovery that would 'gather speed' in 2013, leading to 1.3% growth in the EU and 1.0% in the eurozone. By November 2013 the European Commission acknowledged a likely decline of 0.4% for the eurozone that year alongside 0.0% growth for the EU as a whole, but predicted renewed growth of 1.4% for the EU and 1.1% for the eurozone in 2014. Unemployment would not fall below 11% for the EU as a whole in 2014. The ever optimistic EU Commissioner Olli Rehn (2013) claimed on 13 September 2013 to see signs that the EU economy 'has reached a turning point'.

Economic forecasts are hazardous and revisions are common. Policy makers are often prone to optimism. However, the inaccuracy of forecasts suggests that policy makers were failing to understand the likely effects of their policies. Mistakes included a substantial underestimation of the depressive effects of cuts in public spending, as acknowledged in IMF publications (Blanchard and Leigh 2013). There was also an over-optimistic faith in spontaneous growth from small businesses, an underestimation of the depth and consequences of difficulties in the banking sector and a misunderstanding of the determinants of export success. These mistakes led to the emphasis on austerity and wage reductions which contributed to Europe's poor economic performance from 2010.

The longer-term future remains very uncertain. European Commission forecasts suggest a continuation of their expected recovery for another year, after which they make no predictions. Even this growth is to be modest, 1.7% in 2015 for the eurozone and 1.9% for the EU as a whole. A little growth is indeed likely, assuming there is no further tightening of austerity. However, that will leave Europe barely struggling out of stagnation as widening divergences leave parts of the continent in deep depression.

Economic developments: struggling with stagnation

Figure 1.2 Percentage change in real GDP, 2008 to 2013



Source: International Monetary Fund, World Economic Outlook Database, October 2013.

Diverging stagnation

Differing rates of decline and growth after 2008 led in general to a widening of divergences across the EU. The richer countries tended to do better. Figure 1.2 shows how countries fall into a small number of groups. These do not correspond in any exact way to a division between East and West, between North and South, or between the eurozone and the rest of the EU. This has not been a crisis purely for the eurozone, a category which has itself changed through the crisis with countries joining (Slovakia in 2009, Estonia in 2011 and Latvia in 2014). Its causes are not the choice of currency but past development paths and the forms of financial integration which took similar forms across many EU countries.

The crisis of 2008 hit hardest those countries that had become dependent on inflows of credit from abroad. It hit countries exporting manufactured goods in 2009, but recovery was fairly rapid in 2010. Thus it was exports that started to pull countries out of recession and they continued to grow in the more successful countries in the following years. The downturn after 2010 was most marked in countries facing sovereign debt problems, either directly or following crises in private finance. The worst affected was Greece (GDP down by 23% from 2008 to 2013) while Cyprus, Italy, Spain, Portugal and Ireland all experienced post-2010 decline leading to GDP levels significantly below those of 2008. In all of those cases this followed the adoption of severe austerity policies under varying degrees of pressure from the EU.

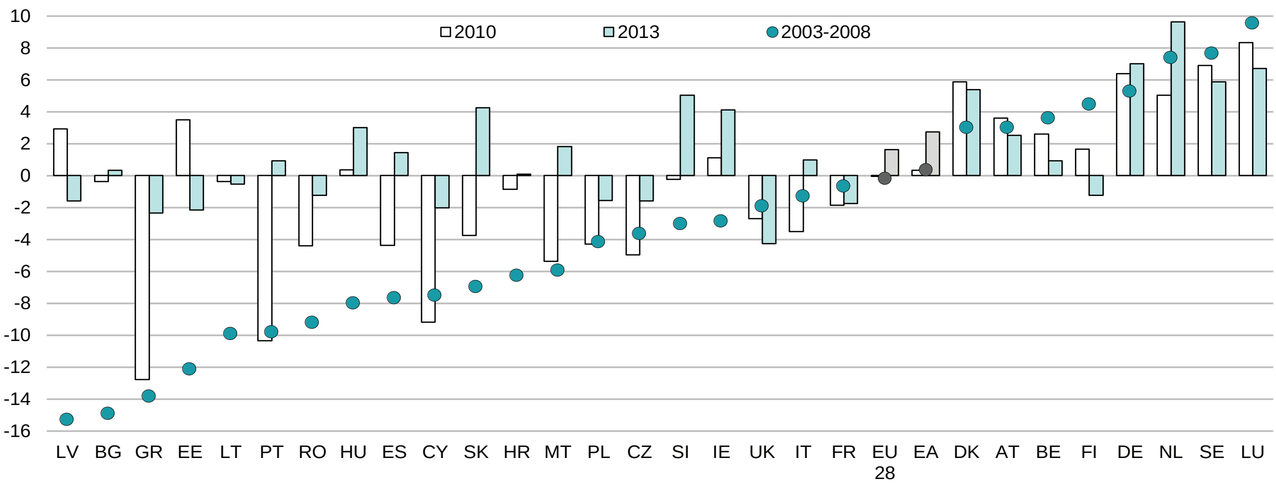
The rest of the EU had broadly restored the 2008 GDP level by 2013, but very few had grown much above that level. Poland was something of an exception with GDP increasing by 13.9%. It was not severely hit by the banking crisis of 2008 – it had not been dependent on credits from outside – and its relatively low dependence on exports meant that it was not severely affected by declining demand in other countries either. It also continued with planned public investment projects, reflected in toleration over some years of budget deficits above the level acceptable for eurozone members (see page 22), while others were cutting back.

The three Baltic Republics were a different kind of exception. They experienced the deepest initial depression – it actually started with decline in 2007 – followed by reasonably strong recovery which slowed down in 2013. The cause of the former was the cut in private credit on which their economies had become dependent. Recovery started shortly after 2009, based on growth in exports, but GDPs in 2013 were still below pre-crisis (2007) levels.

The differing performances of individual countries since 2008 point to three generalisations. Export success has come mostly from modern manufacturing and service industries paying high, not low wages: these remain to be developed in much of the EU. Austerity has brought depression and slower growth across the EU while hitting some countries particularly hard. Economic activity has held up when and where public spending has continued.

Restoring current account balances

Figure 1.3 Balance of payments current accounts, % of GDP



Source: AMECO database.

Turning current accounts into surplus

Figure 1.3 shows the current account balances in EU member states. A number were experiencing substantial deficits in the years up to 2008 which were then generally reduced, or even reversed, in the following years. The overall effect has been to turn the EU deficit from the equivalent of 0.2% of GDP in 2004-8 (0.3% surplus for the eurozone) into a surplus equivalent to 1.6% of GDP (2.7% for the eurozone) in 2013. This major change has been accompanied by depressed internal demand, and some reduction in demand for countries elsewhere in the world.

The current account measures the difference between the values of exports and imports of goods and services. A current account deficit is always balanced either by a surplus on the financial account or by a run-down of the country's reserves. How countries reacted to the crisis depended on whether they had been in deficit and on how they had covered those deficits.

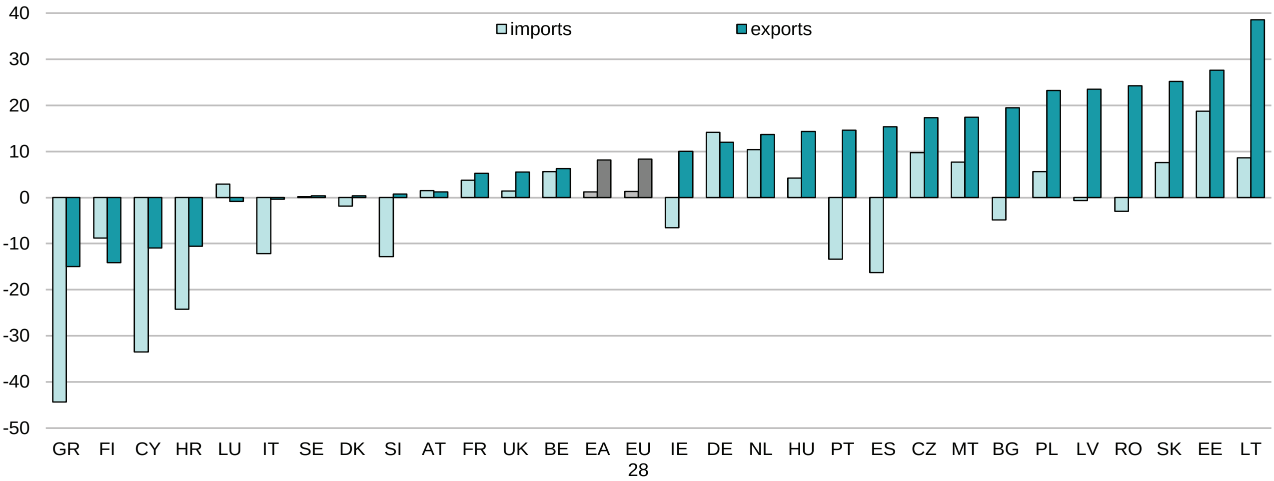
In some, such as Slovakia and the Czech Republic, current account deficits had been covered to a great extent by direct investment in new industries that contributed to subsequent export growth. In others, such as the Baltic Republics, Spain and Ireland, a large proportion of the financial inflows went into private investment in housing and construction which did not contribute to improved international competitiveness. In a few cases the inflows are used to finance government deficits, notably in Greece and Hungary. As demonstrated in Figure 1.3, extreme cases included the Baltic Republics – current account deficits in Latvia and Lithuania in 2008 were both over 13% of GDP – Greece and Portugal. None of these countries had the export potential to balance the import demands of economies growing on the basis of credit from outside.

Another group of countries, notably Sweden and Germany, achieved persistent current account surpluses. Their earnings were one source of the funds that went into credits to countries with current account deficits. Those with surpluses in 2008 have seen them continue or even increase, reaching 7% of GDP for Germany and approaching 10% for the Netherlands.

However, with the EU as a whole in surplus, the external balance should not pose a barrier to an expansion of internal demand. That could most easily be afforded in Germany, Sweden and other surplus countries. They could allow substantially higher wages and increased public investment, thereby also providing a small stimulus to depressed economies elsewhere in Europe. It would not be enough to bring a full return to sustained growth across the EU, but it would be a positive contribution.

Restoring current account balances

Figure 1.4 Percentage changes in exports and imports, 2008-2013, 2005 prices



Source: calculated from AMECO database.

Did ‘internal devaluation’ help?

Figure 1.4 shows the changes in exports and imports that led to the transformation of the EU into an area in net current account surplus with the rest of the world. Variation between countries is enormous. Exports grew most rapidly in the Baltic Republics, Poland, Romania and Slovakia. There was also strong growth in Spain, Germany, the Netherlands and Portugal, but decline in Greece, Italy and Finland and stagnation in Denmark and Sweden. The variations cannot be explained by differences in policies pursued at the time. They depended on countries having products to export and on developments in their export markets. On the other hand, changes in imports relate more clearly to policy choices, falling most sharply where the most severe austerity policies were imposed, such as Greece, Spain and Portugal.

This indicates the actual effects of the policy of so-called ‘internal devaluation’, favoured by the European Commission for eurozone countries in the greatest difficulty. The argument was that, unable within the common currency to devalue, they should achieve the same reduction in export prices by cutting wage costs. This was believed to be the means to stimulate exports and thereby to restore external balance.

The approach was pioneered in the Baltic Republics and also lay behind the Troika policies (see page 24) for Greece, Portugal, Ireland and Cyprus, and policies pressed on Spain and Italy by the European Commission and the ECB. However, internal devaluation did not determine changes in exports. The first emphasis was put on cutting public sector pay and this had minimal impact on export costs. In Greece private sector pay was cut, but export prices actually increased by 20% from 2009 to 2013, the highest increase in any eurozone member for which the average was 8.6% (calculated from figures in European Commission 2013: 141). Lower wages seem to have led only to higher business profits.

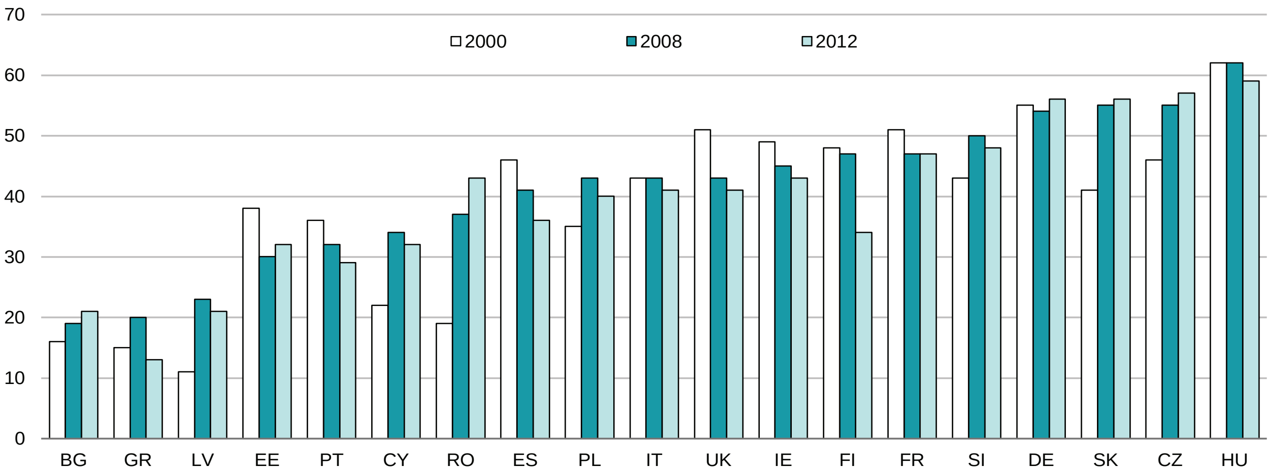
In Latvia, often presented as an example of the success of internal devaluation, pay in export sectors probably increased (Blanchard et al. 2013: 22-23) and export prices increased over this period by 29%.

Ireland is another case of claimed success for internal devaluation, although its GDP was still stagnating in 2013 and export growth in 2013 was barely 0.5%. The success there has been a growth in output from computer services, employing little over 3% of the labour force and paying relatively high wages. The other big contributor to turning the Irish deficit into a surplus has been the fall in domestic demand, leading to the 6.7% drop in imports shown in Figure 1.4. Real recovery depends on finding new activities to replace the jobs lost since 2008, for example, in construction which are equivalent to 9% of the total labour force.

Thus internal devaluation has appeared most effective where it has reduced domestic demand, deepening and prolonging depression. It is not the key determinant of export performance.

Restoring current account balances

Figure 1.5 Percentage share of complex products in selected countries' exports, 2000-2012



Source: Calculated from Comtrade data base.
Note: Complex sectors are SITC 7, 54, 87, 88.

No easy measure of competitiveness

Figure 1.5 shows the changing shares of an indicator of sophisticated products (meaning machinery and transport equipment, pharmaceuticals and scientific instruments) in countries' exports. This is a good starting point for assessing the sophistication of individual economies, albeit not an exact one. The years up to 2008 saw dramatic transformations across Europe. Large-scale manufacturing, especially motor vehicles, was brought by multinational companies to parts of central and southern Europe. The share of complex products rose to over 60% in Hungary and approached that figure in the Czech Republic and Slovakia. Semi-manufactures (steel and bulk chemicals), raw materials and light industry increasingly gave way to machinery and other complex products in those countries' export structures, which came to resemble that of Germany, albeit with dependence on foreign multinational companies for technology and innovation.

The years after 2008 have seen relative structural stagnation. Romania was a striking exception, with growth in modern sectors, while some other countries have continued to lose established activities to lower-wage countries, notably Ireland and Finland. Portugal had moved more slowly from older industries and showed some reversion to the old structure. Greece remained with very little modern manufacturing. Baltic Republics remain exporters mostly of raw materials and simpler products, albeit ones for which markets have recovered.

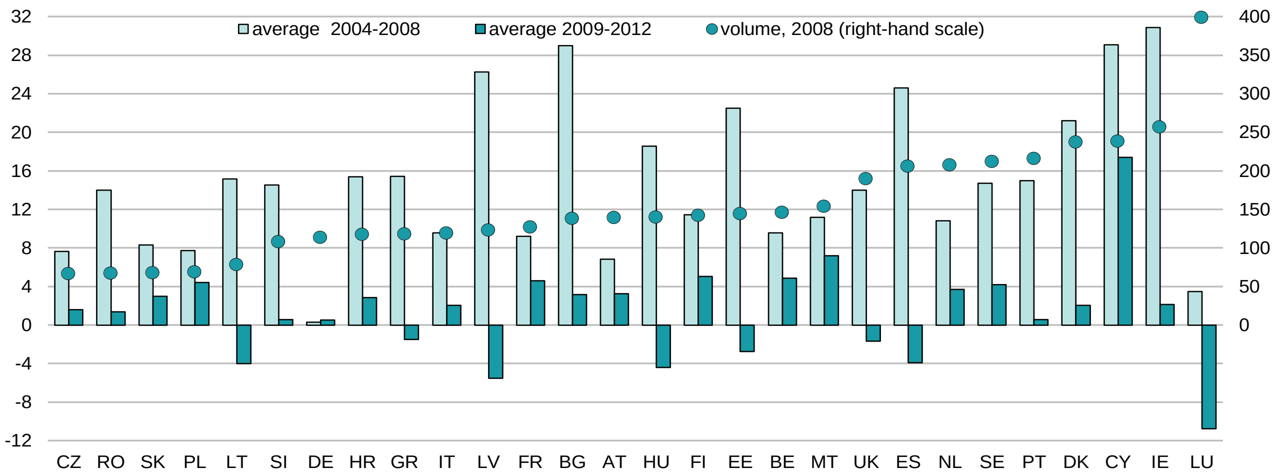
Improving the competitiveness of individual member states and of the EU as a whole has been central to EU economic policy for many years. Targets were set in March 2010 for improving qualifications, skills, research and development output, energy sustainability, social cohesion and active participation in employment as part of the European Commission's 10-year strategy, *Europe 2020*. That strategy remains the formal guide for EU policy targets. It is also in line with much of modern economic thinking within which competitiveness is understood as the ability to compete on international markets *while also paying high wages*. That is the real measure of success.

The crisis has seen a reinterpretation. The target of higher competitiveness is increasingly linked to reducing wages. The key measure has been 'unit labour costs', meaning employment costs per unit of output. Both lower wages and higher productivity can lead to lower unit labour costs. In advanced economies the latter is more important. Countries and firms compete with the quality, sophistication and innovativeness of their products rather than with price. Unit labour costs are therefore low if product quality is high. They are the result of a high level of competitiveness rather than its cause.

The crisis has cut modernisation and investment. Wage reductions cannot counter this trend. Wage levels make some difference over the longer term – modern industries came to central Europe partly because pay was lower than across western Europe – but only in conjunction with investment in infrastructure and skills. An understanding of competitiveness in line with Europe 2020 would point to the need for adequate pay levels to attract, retain and motivate the qualified labour force needed for a modern economy.

From banking crisis to public debt

Figure 1.6 Private credit flow, percent of GDP, 2004-2012 and volume of private credit, percent of GDP, 2008



Souce: Eurostat.

The burden of private debt

The crisis of 2008 was precipitated and transmitted by the private banks. They had lent irresponsibly, both within countries and across borders, and had become involved in speculative and risky activities that were at the time poorly regulated.

Figure 1.6 shows total private debt, including bank credits and other forms of borrowing, in 2008. Levels were generally lower in newer member states, such as the Czech Republic, Slovakia, Poland and Romania, but higher in some other new member states, notably Baltic Republics and Hungary. The highest levels of private debt were in the UK, the Netherlands, Portugal, Cyprus, Spain, Ireland and Denmark. A major component was credit for housing construction and for private house purchase. This latter had an enormous capacity to increase because the availability of credit fuelled increases in house prices which in turn increased the demand for more credit.

The end to easy credit therefore marked the end of housing booms setting off a downward spiral. Figure 1.6 shows the credit flows before and after the crisis of 2008. Increases in lending were extremely rapid in the earlier period in a number of new member states, notably Baltic Republics, Bulgaria and Cyprus. They were also rapid in Ireland, Spain, Denmark and to lesser extents Portugal, Sweden and the UK. The striking contrast is with Germany in which credit growth was minimal. The big difference was that individual ownership of housing is lower in that country and there was no private housing boom in this period.

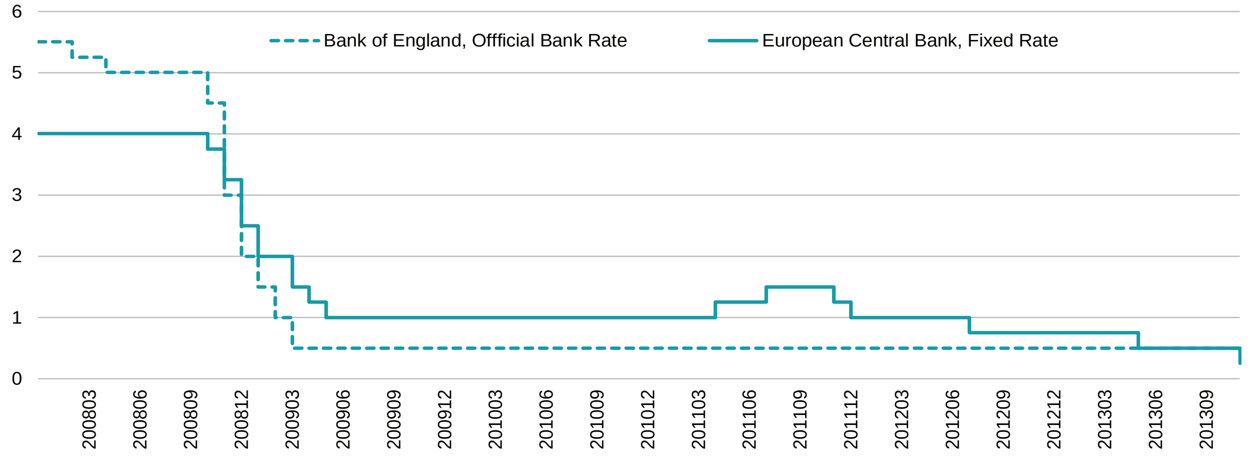
The financial crisis of 2008 and its aftermath led to dramatic reductions in new loans such that the total volume of private credit actually declined in the UK, the Baltic Republics, Greece and Spain. Smaller businesses were the hardest hit and they are more important to the economies in the EU periphery. An ECB survey (ECB 2013: 41-47) for the six months up to March 2013 showed that 85% of SMEs seeking credits in Germany encountered no obstacles, while only 25% in Greece had the same good fortune. Interest rates charged also varied widely, with businesses in periphery countries paying about twice as much as those in Germany.

Causes of these differences included the need for banks to restore their balance sheets. It also followed from banks' fears that demand would remain depressed and credits would not be repaid, a logical fear in countries faced with the most severe austerity policies.

Private debt and difficulties in the banking sector remain very intractable problems. Germany appears the least affected, showing hardly any change in credit growth before and after the crisis. For others the decline in credits has contributed to economic depression and falling incomes. Falling incomes in turn made it harder to repay debts, further discouraging new bank lending. Policies aimed at expanding demand and incomes across the EU would therefore be one form of contribution to restoring bank lending.

From banking crisis to public debt

Figure 1.7 Central Bank policy rates, ECB, BoE, 2008-2013



Sources: European Central Bank and Bank of England.

Help from the central banks?

Figure 1.7 shows one of the key responses to the drop in bank lending from central banks. In an effort to maintain credit flows, they reduced their lending rates, down to historically low levels, 0.25% for the ECB by 2013 and 0.5% for the Bank of England. The change was more rapid and sudden in the latter case, where there was greater concern over the breakdown in private credit. The depth of difficulties in the eurozone was recognised only gradually. These central bank rates, used for lending to commercial banks seeking speedy access to finance, set a lower limit to interest rates on bank credits. However, as Figure 1.6 shows, lower interest rates did not prevent a substantial drop in credit flows.

The Bank of England also pursued a policy of 'quantitative easing'; meaning in effect the expansion of the quantity of money by the equivalent of 24% of GDP. As Figure 1.6 indicates, the UK still experienced contraction, rather than expansion, in net credits. Quantitative easing may nevertheless have prevented still deeper depression. It has not, despite fears of critics, led to higher inflation. It has probably contributed to maintaining share prices, in which case the main benefits have been to the wealthiest in society.

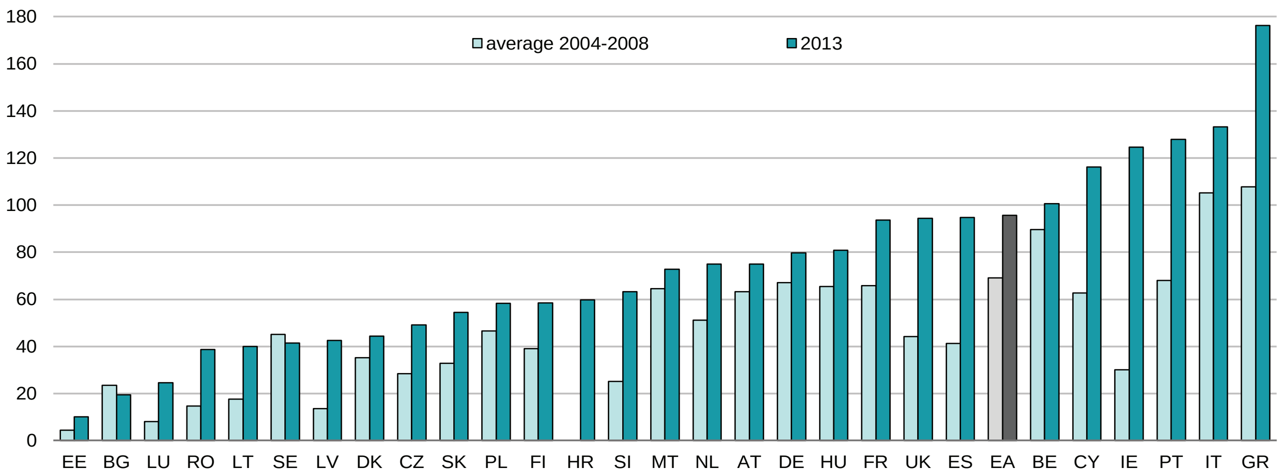
The ECB has not formally followed this route, but a similar effect could have been achieved by its decisions in 2011 and 2012 to offer cheap three-year loans to banks to the equivalent of 14% of eurozone GDP. In practice most of this went into countries facing public debt problems and banks used the resources to improve their own balance sheets or to lend to their governments. This therefore reduced the interest rates paid by governments especially in Greece, Ireland, Italy and Spain. It did not revive credits to businesses or households.

The measure has not been repeated, following opposition from some member states that see themselves subsidising the troubled countries of the periphery. Instead, attention has focused on solving banking sector problems by the creation of a European banking union, following an EC proposal of May 2012.

However, the proposal agreed in December 2013 is unlikely to contribute much. The ECB should become a central regulator for bigger banks, but it has yet to prove that it would be better at spotting risky behaviour than national central banks. A fund will be established for banks facing difficulties, building up to 55 billion euros after 10 years. That is a small amount compared with the 473 billion euros already spent on bank rescues. It will do nothing to overcome the divergences in current banking behaviour. It is more aimed at preventing another crisis in the rather distant future, but it may not do very much towards that either.

From banking crisis to public debt

Figure 1.8 Gross public debt as percent of GDP



Source: AMECO database.

After private debt came public debt

Public debt problems followed after the private debt crisis. Figure 1.8 shows public debt levels in EU members which changed little relative to GDP between 2000 and 2008, increasing slightly in a few and decreasing in somewhat more countries. The highest levels, in Greece and Italy, were little different from those in 2000. The lowest level was recorded in Estonia, falling to a low point of 3.7% of GDP in 2007. Figure 1.8 shows that, with the exceptions of Bulgaria and Sweden, the debt to GDP ratio was higher in 2013 than the average for 2004 to 2008.

The private debt crisis was transformed into a problem of public debt by three mechanisms:

- the first was that governments were obliged to rescue failing banks. This was done in the UK by the central bank, the Bank of England, acting as lender of last resort. In 2008 it provided the funds to keep banks operating, taking several into state ownership, and there was no formal increase in public debt. Had the extent of this rescue been measured as a cost to the state, public debt would have been increased to 155% of GDP in 2012, not far behind the Greek figure. Within the eurozone the European Central Bank did not act as a lender of last resort. Thus the Irish government used public money to rescue an insolvent bank, contributing to the doubling of public debt between 2008 and 2010.
- the second was that the fall in GDP in 2009 was countered by continued public spending, and by increases in some items both to cover costs of higher unemployment and to prevent a still deeper depression. Budget deficits were covered by borrowing.
- the third was that continued depression, reducing GDP and also tax revenues, made it even more difficult to hold back budget deficits which were covered by more borrowing.

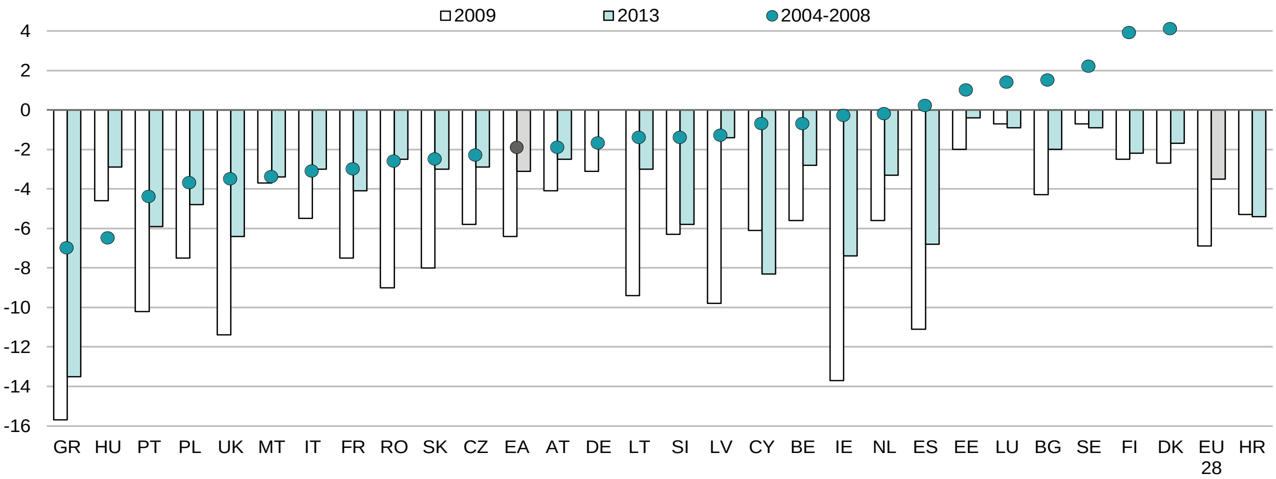
There is no precise level of debt-to-GDP ratio at which public debt levels become unsustainable, in the sense that further borrowing becomes impossible or requires an unacceptably high interest rate. Past experience shows very varied levels of debt leading to a loss of confidence from potential purchasers of government debt. The eurozone sets a formal limit of debt at 60% of GDP, a figure exceeded by all but a few eurozone members in 2013. However, the eurozone remains particularly vulnerable to a loss in investor confidence because of its prolonged depression – lack of growth means lack of growth in public revenues that are required to repay debts – and also because the ECB has been very reluctant to behave as a lender of last resort.

The result is a paradox of uneven development. Some countries have faced extreme difficulty in raising loans. The yield on 10-year Greek government bonds in October 2013 was 8.74%, a potentially crushing burden for a country facing escalating public debt. Others have been paying interest rates on long-term credit that are little above zero in real terms. For Germany the equivalent figure was 1.76%. Funds are there to be invested. Government debt from Germany, the UK, France and several other EU member countries seems the safest investment available.

Thus, when taken as a whole, there should not be a debt crisis for the EU, or even for the eurozone. Mobilising the financial resources available in pension funds, investment funds and other forms of saving should be a central part of any policy for restoring income levels and growth across the EU.

Cuts that lead nowhere

Figure 1.9 General government surplus as percent of GDP, 2004-2013



Source: AMECO database

Reinterpreting the crisis – cutting budget deficits

As Figure 1.9 shows, the crisis of 2008 led to a worsening of state budgets with all countries running deficits in 2009. Only two had recorded high levels in the 2004-8 period, Greece and Hungary, and the latter saw reductions after 2008. As the crisis was reinterpreted from one of private finance to one of public debt, so the emphasis shifted from using the public sector to provide a stimulus to the economy to minimising state budget deficits.

After the leeway allowed in 2009 to counter the crisis, eurozone members were again under pressure to reduce deficits to within the 3% limit. As shown in Figure 1.9, the average eurozone level fell from a deficit equivalent to 6.4% of GDP in 2009 to 3.1% in 2013. Levels for the EU as a whole were slightly higher, at 6.9% of GDP in 2009 and 3.5% in 2013. These included the need to pay interest on debts, which rose slightly to 2.9% of EU GDP in 2013 but with somewhat higher levels for countries in the most difficulty. The peak was 7.1% for Greece in 2012 without which its deficit for the year would have been only 2.4% of GDP.

These reductions were achieved by the following means;

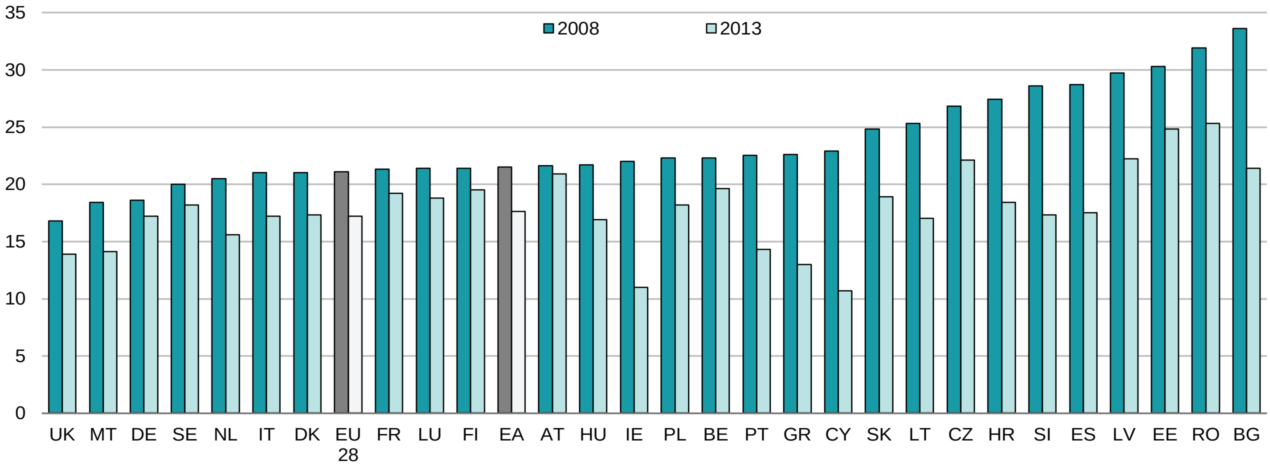
– some enormous deficits, such as a 30.6% of GDP in Ireland in 2010, were largely due to the need to bail out banks in the absence of a central bank acting as lender of last resort. These were one-off payments that did not need to be repeated every year.
– some taxes were increased. The favoured ones were indirect taxes, such as VAT, while direct taxes on incomes and profits actually fell from 13.3% to 13.0% of GDP across the EU between 2008 and 2012, albeit with large variations between countries. Indirect taxes tend to be less progressive, suggesting that those on higher incomes contributed less than others to reducing budget deficits.
– cuts were imposed on current public spending, including state benefits and unemployment support, often by reducing the time of entitlement. Other areas for cuts in the most severe austerity programmes were public sector pay and pensions.
– cuts were imposed on public investment exacerbating, rather than countering, the effects of the failure of private credit.

Reducing public sector deficits is presented by the European Commission as a great success. This is one target that seems achievable in most countries, albeit with the least success in the most depressed. However, public sector cuts have also contributed to the poor economic performance since 2010. European economies have been dependent on exports to provide any economic stimulus.

Some countries clearly could expand their public spending. Germany is the clearest case, having completely eliminated its budget deficit by 2011. Such demand-depressing austerity is surprising for a country that can borrow at minimal, if not negative, real rates of interest, particularly when public investment has been for many years at an extremely low level (see following section).

Cuts that lead nowhere

Figure 1.10 Gross fixed investment as % of GDP, 2008 and 2013



Source: Eurostat.

Reversing the downward spiral of investment

Figure 1.10 shows that investment has fallen dramatically in the aftermath of the crisis, but with wide divergences in experiences of countries. GDP in 2013 for the EU as a whole was 1.3% below its 2008 level, but total fixed investment had fallen by 18.8%, from 21.1% of GDP to 17.2%. In some countries – notably Germany, Austria and Sweden – there was little net change over this period. For some the drop was enormous. In Ireland investment fell from 25.5% of GDP at its peak in 2007 to 11.0% (of a lower level) of GDP in 2013.

Most of the decline was in private investment, including housing construction and industry, but public fixed investment also fell by more than 50% in Ireland, Spain and Greece. It held up well in some periphery countries, remaining roughly unchanged in the Baltic Republics where there was a large contribution from EU support. The highest level was retained in Estonia at 4.6% of GDP in 2013. Germany and Austria were the lowest, both in the years before the crisis and in 2013, with levels of 1.5% and 1.0% of GDP respectively.

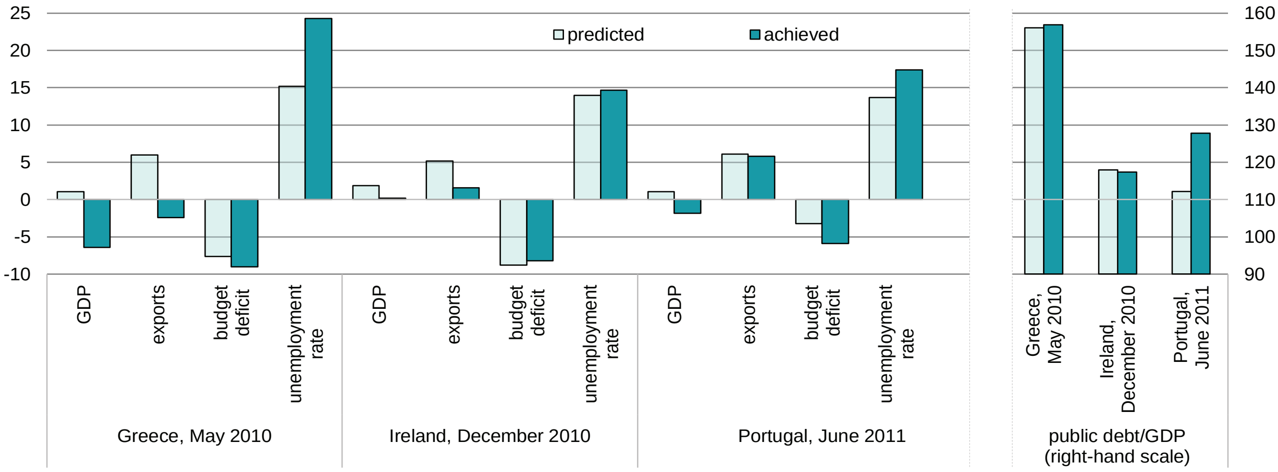
Some past investment was misdirected, contributing to the construction and housing bubbles that led to the banking crises. However, levels are extraordinarily low in a number of countries, leaving unemployed people and unused capacity that could contribute to a revival of well-directed investment activity.

A revival in investment activity would provide an immediate stimulus to demand. It is also essential for long-term growth and for overcoming growing divergences and inequality within the EU. All countries have demonstrable needs for investment to cope with the challenges of the future in such areas as education and research, climate change, energy, environment, and ageing of populations. All could benefit from increased public investment undertaken by their own governments. A clearly European investment programme, using existing methods and institutions of Structural Funds and the European Investment Bank, could help direct investment towards reversing the widening divergences in economic performance across the EU.

As indicated (on page 21), financial resources are available and actively seeking safe investment opportunities. However, their utilisation has been blocked by the determination to avoid extra borrowing even for productive purposes and even though policies pursued have actually led to sustained increases in public debt levels. Borrowing in one form or another has always been the standard means for financing investment, both private and public. When it leads to growth, debts are relatively easily repaid.

Cuts that lead nowhere

Figure 1.11 Results of Troika policies in three programme countries, 2010-2013



Sources: European Commission, Autumn Forecast 2010, 2011, 2013, Spring Forecast 2011.
Note: GDP and export figures show percentage growth, budget deficits are percent of GDP.

What the Troika did

From 2008 onwards a number of EU member states have been hit by the inability to sell bonds – meaning public debt – on the international markets. The first major problem was in Hungary in November 2008, followed by Latvia and Romania. Help came from the IMF and EU with conditions attached that required cutting budget deficits. These packages reached a completely new scale when Greece, a eurozone member, was affected in 2010. Its government admitted that previous public deficit figures had been inaccurate and private investors lost confidence in Greek public debt.

The Greek crisis saw the rise of the Troika, bringing together the EC, the IMF and the ECB, but with the last of these playing no significant role. They provided emergency credit, but with high interest rates and with a range of further conditions attached. The package failed to resolve the Greek crisis and a further bail out was required in March 2012. The total volume of credit made available was greater than in any previous IMF programme, equivalent to 25% of Greek GDP. Rescue packages were also devised for Ireland in December 2010 and Portugal in June 2011. Results are set out in Figure 1.11, showing the predictions for the next two years from the European Commission's first regular forecast after terms were set out, compared with results actually achieved.

Budget deficit and debt figures were not too far off target. These were priorities and further budget changes were required if the target looked like being missed. GDP figures were significantly worse than predicted and unemployment results were somewhat worse than forecast. Exports were not bad for Portugal but well below target for the other two. As covered in Sections 4 and 5, these depend on factors that cannot be changed quickly. The Troika's policies made little difference there, despite their optimistic predictions.

The main effects of the Troika's policies have been to depress demand, leading to lower GDP and to increasing debt levels, the former not foreseen but the latter partly acknowledged in their forecasts. In fact the debt to GDP ratio for Greece escalated to 176.2% in 2013, as depressed domestic demand reduced the GDP level and tax revenues. There is no basis for expecting a reduction in that debt level in the near future and a further bail out(s) may well prove necessary.

The terms required by the Troika did not end the crises in the eurozone. They prolonged them. Failure to resolve the issue in Greece encouraged doubts about ever more countries, including Portugal and Ireland but also Spain and Italy. This domino effect would have been prevented had the ECB followed the example of central banks elsewhere in the world and acted as a lender of last resort, guaranteeing debts of eurozone members. That would have killed investor fears from the start.

In September 2012 the ECB finally stepped in to buy state debt from the countries in the greatest difficulty. This implicitly guaranteed new debt from eurozone members, putting a stop to speculation about countries leaving the eurozone. However, conditions attached have continued to hamper prospects for economic recovery.

Conclusions

Where to find the alternatives

The European economy has gone through two depressions since 2008. The first policy reactions to the crisis in 2008 suggested that the EU was on the right track. The fall in private sector activity was to be countered by a stimulus from the public sector. The second depression, after 2010, followed after the reversal of that early approach. The European Commission predicted at the time a fairly quick recovery. By 2013 it was more cautiously promising only that a turning point was at hand. Taken as a whole the EU economies are facing the prospect of an agonisingly slow recovery in which several are being left behind. There is no likelihood of a return to the growth and employment rates of the period up to 2008.

When the overall picture looks disappointing, emphasis has been placed from the European Commission on some particular countries that are presented as the way forward for all. Baltic Republics have figured prominently.

These countries suffered an early and deep depression following restrictions on the inward flows of credit that had sustained their economies up to 2007. They underwent some recovery from the depths of depression, albeit not growing as rapidly as in the years up to 2008. This was possible because of quite specific circumstances. Their troubled banks were largely foreign-owned – with one significant exception in Latvia – and they mostly received external funding rather requiring state help. Their traditional export markets recovered quickly and there was some inward investment from manufacturing companies. They also experienced high levels of emigration, equivalent to 8% of the population for Latvia, which reduced the need to pay benefits for the unemployed. Baltic Republics also received high levels of EU support, equivalent to up to 8% of GDP, which held back the fall in their investment levels.

It should not be difficult to find a better way forward for Europe Union. Economically it is one of the most advanced parts of the world. It is in current account surplus with the rest of the world. It has no difficulty accessing private finance, as evidenced by the very low rates of interest on long-term government debt paid by a number of EU governments. Restoring growth, prosperity and employment levels requires mobilising the resources that exist for modernisation and investment.

Recovery is held back both in individual countries and at EU level by fears over levels of public debt. In fact, public debt has grown because of the crisis – and because of austerity - rather than being its cause. It will continue to increase as a proportion of GDP as long as growth remains subdued. This is an absolutely basic proposition in macroeconomic theory and is confirmed by Europe's post 2008 experience. Gross debt as a proportion of GDP has increased across the EU and, with only a couple of exceptions, in every country and every year since 2008. Reversing that trend requires renewed growth, providing the growth in tax revenues which can reduce budget deficits.

Renewed growth requires renewed investment, both public and private, and renewal of bank lending. None of these can come on an adequate scale from the current policies of austerity. Public investment can be undertaken through existing institutions, the Structural Funds and the European Investment Bank at EU level, and other national institutions. It can be financed by borrowing. That would increase debt levels, but would generate the growth from which those, and previous, debts could be repaid. There is no other feasible way to resolve debt problems.

Private investment can be expected to increase following a stimulus from public investment. It would benefit enormously from a restoration of bank lending. That in turn would be helped by completion of negotiations over a banking union. However, for such an approach to be fully effective requires that means be found to ensure that banks in difficulty can continue to function normally, offering credits to businesses with sound investment plans. That requires the creation of an adequately funded lender of last resort.

Recovery also requires current spending from governments. They cannot take advantage of investment opportunities if they cannot pay interest on loans. There is also little point in trying to modernise societies, for example with new facilities for education, research and health, if there are no resources to pay the employees. Therefore, at least until growth is restored, the rules on fiscal deficits and debt levels need to be interpreted much more flexibly. More radical measures would include steps towards mutualisation of public debt and/or for the ECB to take on more clearly the role of lender of last resort. This would enable the countries facing exorbitant interest rates on their public debt to borrow again at rates comparable to those of the most favoured EU members.

It is not difficult to find alternative policies for Europe that could restore growth and employment. Europe, after all, has been performing exceptionally badly in comparison with the rest of the world. Without a change of course it risks losing the next five years as it has the last.