

## 2. Macroeconomic developments and policy issues

### Introduction

Macroeconomic policy developments and policy discussions in the European Union in 2009 were, obviously, dominated by the economic crisis that manifested itself starting in the late summer of 2008. The trigger is widely seen as the collapse of Lehman Brothers, a major Wall Street investment bank, on 15 September 2008. However, the crisis had deeper roots (Watt 2008), for the prevailing concept of *laissez-faire* financial capitalism had implied that profits, in particular in the financial sector, could grow at double-digit rates while overall economic growth remained in the low single-digit range. This led to a shift in income distribution at the expense of employees and low-income groups, i.e. a shift of national income from labour to capital and/or within wage income to the wealthy. The concentration of wealth resulted in a weakening of broad-based demand. Two opposite growth models emerged, both of them based on the necessity to compensate increasing income inequality with other sources of demand: either increased household borrowing (e.g. US, UK, Spain) or export-led growth (Germany, Japan, China). Rising global economic imbalances were the result. Both growth models proved economically unsustainable, and the world economy entered into the worst recession since the Great Depression of the 1930s.

This chapter focuses on the scars left on the European economy by the economic crisis. Section 1 charts the output losses across Europe and in comparison with other countries of the world. It touches on the labour market effects (for more details see Chapter 3) and then describes the impact on government budgets. In Section 2 the policy responses by European countries are examined, with some discussion of the particularly interesting question of why Europe has been harder hit than the US, the epicentre of the crisis. Finally, we peer into the future and consider some of the longer-term effects (section 3). Will Europe suffer a lasting loss of output from the crisis and what are the implications for public budgets in the longer run: are we sitting on a public-finance time-bomb?

### Themes

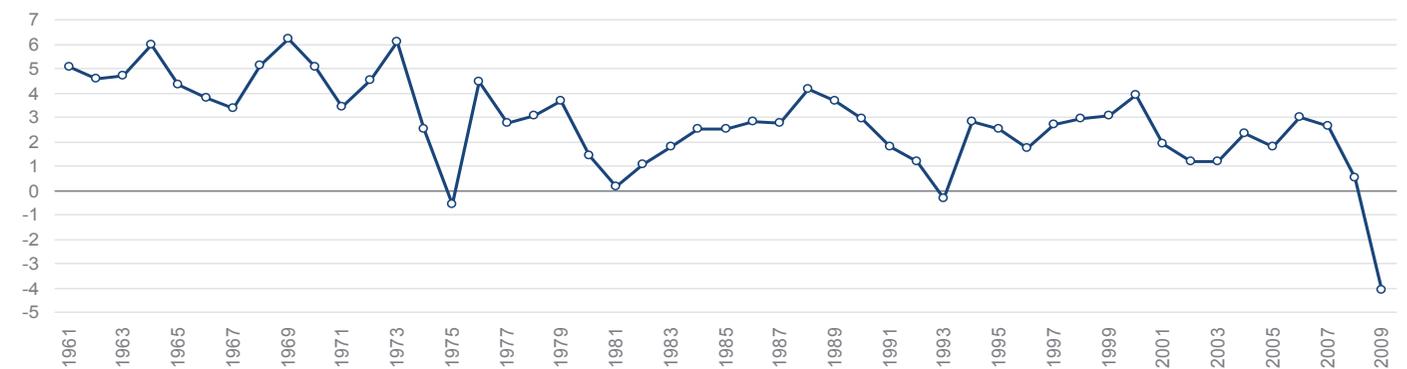
- 2.1 The scars of the economic crisis
- 2.2 Benchmarking the macro-economic policy response
- 2.3 Looking ahead: how long-lasting will the impacts be?
- 2.4 Conclusions

## 2.1 The scars of the economic crisis

### Output and growth

The economic crisis that began in the last quarter of 2008 was unprecedented in the history of the EU (Figure 2.1). On only two occasions, in 1975 and 1993, had the fifteen 'old' Member States experienced negative – and in both cases very slight – year-on-year economic growth rates. The contraction by more than 4% was a 'black swan' event: it had been considered inconceivable. Even if the higher trend growth in the 1970s is taken into account, the fall in the growth rate of more than 7 percentage points is also unprecedented in post-war western Europe. The only comparison is with the (oft-mentioned) Great Depression of the 1930s and the (oft-ignored) 'transformation' crisis in Eastern Europe (and Finland) at the start of the 1990s.

Figure 2.1 Gross domestic product at 2000 market prices, % change on previous year



Data source: AMECO.

## 2.1 The scars of the economic crisis

### Output and growth

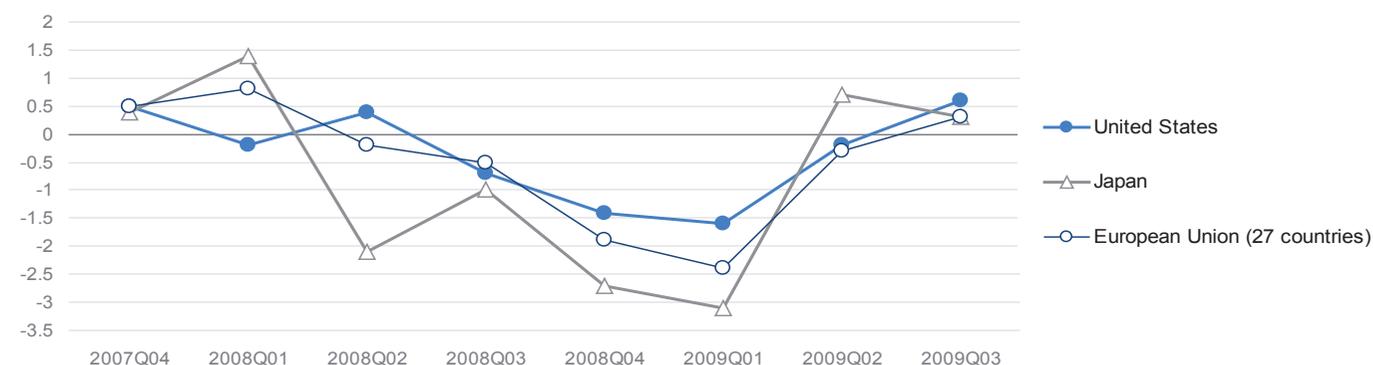
Figure 2.2 zooms in on the crisis period itself, using quarter-on-quarter growth rates, and permits a comparison with two major trading partners, the USA and Japan. In Europe the recession lasted for five consecutive quarters – recall the traditional definition of a recession as just two consecutive quarters in which output contracts – with the bulk of the output losses at the end of 2008 and start of 2009. Readers may well be surprised to see that the USA – the epicenter of the crisis, the originator of most of the toxic assets, and a country with huge trade and budget deficits as it entered the crisis – experienced a decline less steep than in Europe. Japan, on the contrary, fared even worse, despite being a surplus country and one with no prior speculative asset boom (cf. Horn *et al.* 2009). Though it is too early to tell for sure at the time of writing, forecasts suggest that the US may also be recovering from the crisis faster than the European economy.

Unfortunately, comparable (quarter-on-quarter) data are not available for China. But the basic picture is clear: the growth rate halved from (annualised figures) around 13% at the end of 2007 to a nadir of 6.1% (Q3 2008 compared with the same period a year earlier). But China has since accelerated out of the trough and growth rates

are rapidly rising again towards prior levels. Brazil, India and other large emerging markets, hit by the crisis to differing extents, also seem to have in common a relatively swift rebound.

In searching for explanations for these trends, we look first at the output losses across Europe, focusing on the differences between countries, and also at the composition of the output losses, before moving on, in the next section, to consider the policy responses.

Figure 2.2 Real GDP growth, quarter-on-quarter, %



Data source: Eurostat.

## 2.1 The scars of the economic crisis

### Output and growth

The cumulative loss of output (taking the level of the first quarter of 2008 as the starting point and the second quarter of 2009, when the recession ended in the EU as a whole, as the end point) varied very greatly around the EU average of slightly more than -5% (Figure 2.3). It ranged from around just half a percentage point in Greece and Cyprus to a massive collapse, almost one fifth of output, in the three Baltic States. Poland, alone among the EU27, recorded positive economic growth over the period.

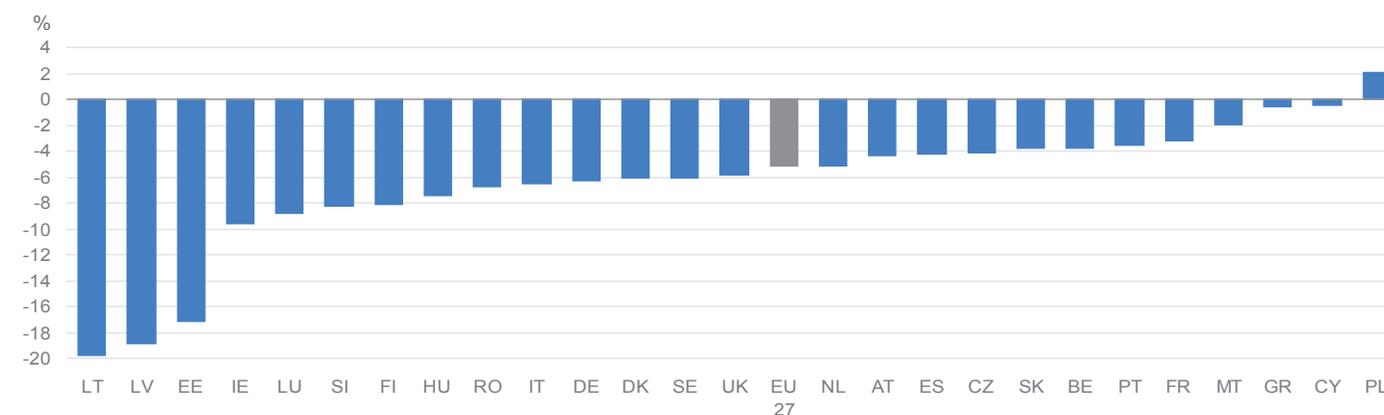
No simple regional pattern emerges from this distribution. Notably, CEE countries are to be found at opposite ends of the spectrum. Southern Europe appears to have fared comparatively well in terms of lost output in this period, Italy being a notable exception. Clearly the existence of prior booms and asset prices bubbles is a factor, and the Baltic States and Ireland are cases in point here, although the output loss in the UK is only slightly above, and that in Spain somewhat below, average. There is some indication that otherwise similar countries may have been hit differently depending on their openness to trade: this may be one reason behind the marked difference in the experience of France and Germany, for instance, or the Nordic countries compared with Portugal. Dependence on

capital imports was also an important factor, especially in some CEE countries. The size of the financial services sector clearly played a role in the case of Ireland and Luxembourg, although here too the middling position of the UK would seem puzzling, on the basis of such 'structural' characteristics alone. Such discrepancies may indeed be suggestive of the influence of national economic policy (section 2).

A further clue comes from the composition of the output changes at the level of the euro area (on this see European Commission 2009f). In the decisive winter half-year 2008/9, 1.8 percentage points of euro area output was lost

due to the fall in net exports, and a similar amount due to the collapse in investment. By contrast, the loss of output due to private consumption was just 0.6 percentage points. This implies that countries that are highly open to trade and have a high investment share were likely to suffer disproportionately, which is part – but only part – of the explanation why Japan and the EU suffered greater output losses than the US.

Figure 2.3 Change in output, 2008Q1 to 2009Q2



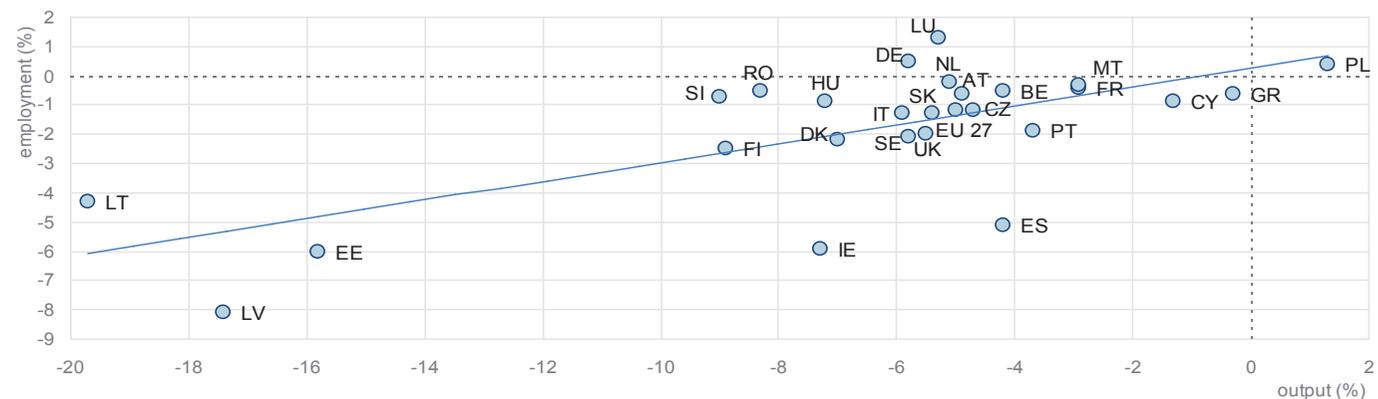
Data source: Eurostat.

## 2.1 The scars of the economic crisis

### Employment

Contractions in economic output inevitably have serious repercussions for employment. The labour market impacts of the crisis receive a detailed analysis in the next chapter of this report. One key point should, however, be mentioned in the context of this macroeconomic analysis. The pattern of output losses across the EU countries was broadly commensurate with job losses, as can be seen from the trend line in Figure 2.4. However, while countries such as Ireland and the Baltics have shed employment roughly in proportion to the output contraction, and in Spain job losses were actually greater in percentage terms than the drop in output, companies in many continental European countries, notably Germany, have retained workers in the face of falling demand and production. In the short run this has reduced the demand shock to the economy, as workers have been better able to maintain spending. By keeping workers within existing companies, moreover, countries that have practised 'labour hoarding' will be differently placed when the upturn comes (see below).

Figure 2.4 Change in output and employment, 2008Q2-2009Q2



Data source: Eurostat (2009) *European Labour Force Survey* and *National Accounts*. Age 16-64.

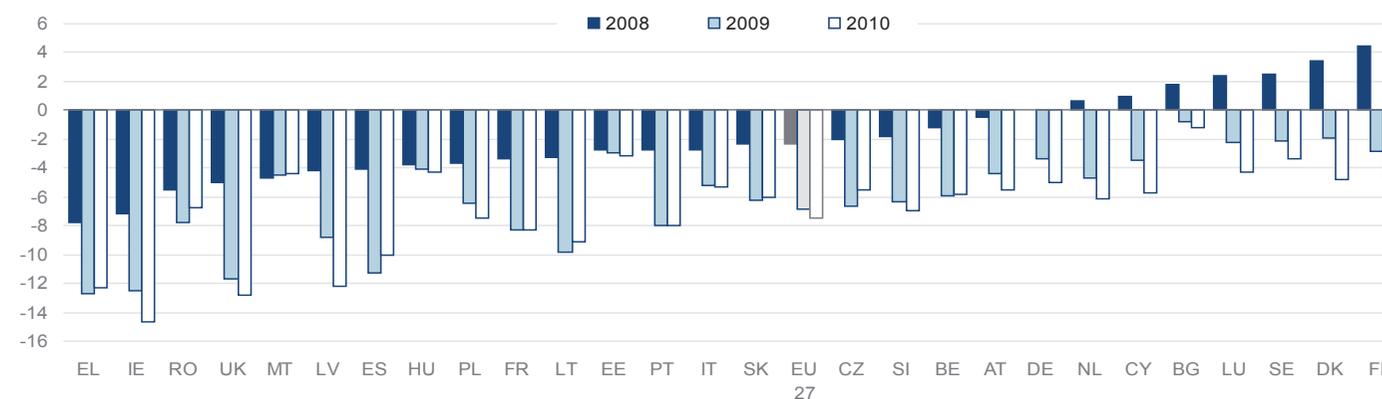
## 2.1 The scars of the economic crisis

### Public finances

The second decisive impact of falling output is a deterioration in public finances, in other words, rising current government deficits and higher levels of government debt. This worsening of public finances is the sum of two components. The so-called 'built-in stabilisers' cause a fall in tax receipts and an automatic increase in spending in areas such as unemployment and other benefits. On top of this come discretionary policy measures in response to the crisis (for more on such discretionary policy see section 2.2 below).

Figure 2.5 shows the increase in government deficits and Figure 2.6 that of government debt. From 2.3% of GDP in 2008 the EU27 deficit shot up to more than 6% in 2009 and is expected to reach around 7.5% in 2010. As with (un)employment, the small but steady improvements in public finances achieved over an extended period have been wiped out by the crisis in the space of twelve months. Whereas eight countries posted a surplus in 2008, every single one was in deficit a year later. Ireland, Greece, Latvia and the UK are forecast to have government deficits above 12% of GDP in 2010, and, with the sole exception of Bulgaria, all EU27 countries will have a deficit above the 3% of GDP Maastricht ceiling.

Figure 2.5 Government budget deficit/surplus (% GDP)



Data source: AMECO (2009 estimate, 2010 forecast).

## 2.1 The scars of the economic crisis

### Public finances

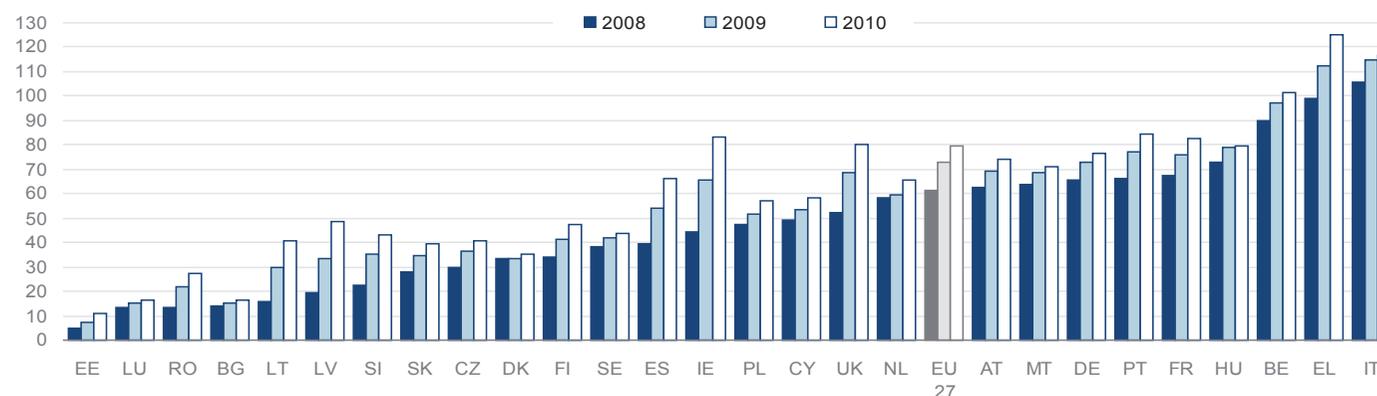
Repeatedly high deficits lead, of course, to higher government debt. On average the public sector debt burden will increase from just over 60% of GDP – actually the Maastricht ceiling – to around 80% in 2010, a new record. Three countries will have debts in excess of one year's GDP, implying a need to raise taxes equivalent to at least the rate of interest (4-5% normally) as a share of GDP simply in order to pay the interest on the national debt.

These figures have given rise to an anguished debate about fiscal sustainability. We return to this subject below, but already here it is essential not to lose sight of the fact that the discretionary and automatic measures were vital in stabilising European economies in the crisis; they are the mirror image of the fact that the private sector, which in the boom had on average wanted to take on more debt, suddenly wanted to save more (deleveraging).

During 2009 policymakers and commentators displayed an increasing sense of satisfaction about the policy response. First of all, global meltdown had been avoided. Then, gradually, the worst fears about the extent of output and job losses were able to be overcome. And at the time of writing there are clear signs of a – weak – recovery. Assuming for the moment that this is

the case – for there is still a not insignificant risk of a renewed plunge into a double-dip recession – can we join in the chorus of (self-)congratulation with respect to Europe's policy response? In the next section we will consider, in turn, monetary and fiscal policies.

Figure 2.6 Government debt, gross (% GDP)



Data source: AMECO (2009 estimate, 2010 forecast).

## 2.2 Benchmarking the macroeconomic policy response

### Monetary policy

Figure 2.7 shows the policy rate set by the ECB, the Bank of England and the US Federal Reserve in the crisis. The interest rate hike by the ECB in June of 2008 had been a mistake, as was evident not only with hindsight (*Benchmarking Working Europe 2008: 21; ELNEP 2008*), and showed the problems of – as President Trichet likes to put it – having only one needle (i.e. inflation) in one’s monetary policy compass. The two other leading central banks had already started to reduce rates. Belatedly the ECB did cut rates, more or less in line with the central banks of the US and UK. During this period, central bankers were rightly praised for avoiding the mistakes of the Great Depression and for making ‘money cheap’ in an attempt to counter the contractionary forces battering the economy. However, the ECB never cut its policy rate below 1%, that is half and at least three quarters of a point higher than those in the two English-speaking countries. Though this would normally point to a tighter monetary policy stance, such an interpretation would be, in the current situation, somewhat misleading. By making unlimited amounts of money available to the banking sector, the ECB has driven market interest rates (the rates at which banks lend to each other) below the policy rate, and down to levels similar to those prevailing in the UK and US. To that extent, monetary policy can be

argued to be as expansionary in the euro area as in the pound or dollar area.

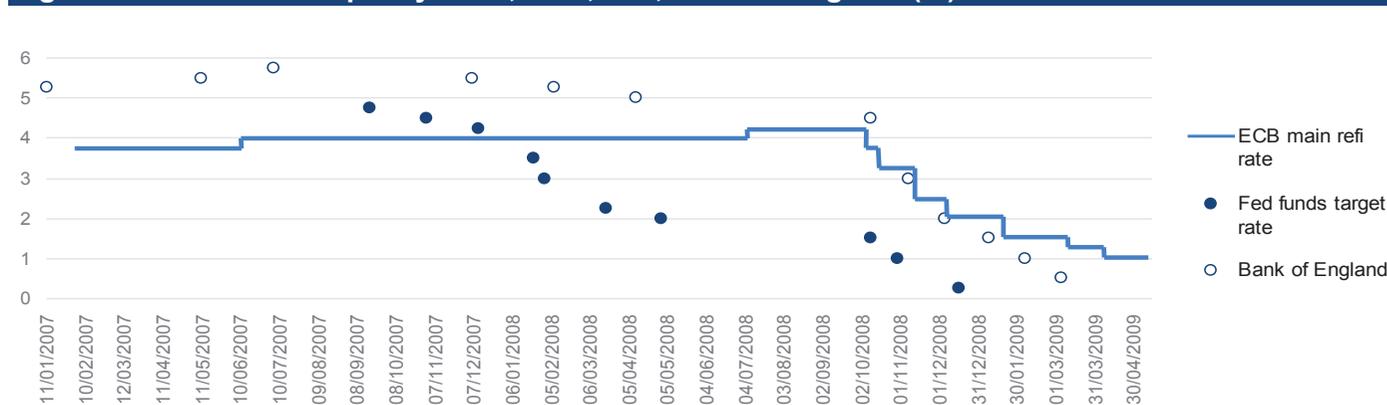
On the other hand, though, the ECB has largely refrained from directly buying private or public sector securities from the public. This so-called ‘quantitative easing’ policy is more informally known as ‘printing money’, as the central bank creates the money with which to purchase these securities, and is used to stimulate the economy when policy rates are as low as they can get. Both the Federal Reserve and the BoE have ‘expanded their balance sheets’, i.e. printed money with which to purchase more than USD 1 trillion in assets and GBP 200 billion respectively. On

this measure the ECB was less active in stimulating the economy. Moreover, the exchange rate forms an important (and often overlooked) element in the overall monetary conditions. Prior to the crisis, currency appreciation had often been associated with sluggish growth in the euro area (*Benchmarking Working Europe 2008: 13f.*). The rise of the euro against both the pound sterling and the dollar, of the order of 25-30% (due, not least, to the aforementioned reluctance to use quantitative easing policies in Europe and its extensive use in America and Britain), is putting downward pressure on both growth and inflation in Europe at a time when neither is desirable; this

factor also indicates that monetary conditions are tighter in Europe than suggested by policy rates.

To sum up, evaluating the stance of monetary policy is somewhat complex, but a clear conclusion can be reached. Yes, the ECB did make unprecedented efforts (after an initial mistake) to stimulate the European economy. However, it did not do as much as other leading central banks. And once the exchange rate is taken into consideration, monetary conditions have been substantially tighter than necessary, given the loss of output and below-target inflation, and less expansionary than in other world regions.

Figure 2.7 Central bank policy rates, ECB, Fed, Bank of England (%)



Data source: ECB, US Federal Reserve, Bank of England.

## 2.2 Benchmarking the macroeconomic policy response

### Fiscal policy

As we have seen in Section 1.3, the crisis has blown huge holes in public finances. Does this mean, conversely, that the fiscal policy response to the crisis in Europe was appropriate, that is highly expansionary? In some respects the answer to this question conforms to the pattern identified for monetary policy. Initially mistakes (here of omission rather than commission) were made. Subsequently a response was forthcoming that was indeed of historic proportions. However, in comparison both with other countries and with Europe's possibilities, more could have been done. The table in Figure 2.8 provides an overview of the extent of the discretionary measures adopted by mid-2009 for that year and 2010 (given the signs that the economy is picking up, very few such measures have been adopted since).

Space prevents a more detailed discussion (see Watt 2009a and Watt 2009b for details), but the key findings on the performance of fiscal policy in the EU can be summarised as follows:

- Political delays and initial failure to recognize the seriousness of the situation in Europe meant that stimulus measures were not launched in most countries until the spring of 2009. Stimulus came too late to cushion the economy against the

negative forces at the end of 2008 and start of 2009.

- After a delay, European coordination was quite effective in avoiding the free-rider problem (as shown by the lack of correlation between country size and the size of the package as a share of GDP; Watt 2009a: 17).
- The overall size of packages was much too small – around 1% in 2009 and 0.6% in 2010 – given the magnitude of the shock (6-7 p.p. of GDP).
- Even allowing for the larger automatic stabilisers, as compared to

the US, the overall size of the fiscal response was smaller than in the US and also in China.

- Analysis of the distribution of the size of packages across countries showed some positive features (e.g. a positive correlation with the size of the negative output shock) but also some negative ones (notably clear evidence of real or imagined fiscal constraints limiting the size of anti-cyclical measures) (Watt 2009a: 15ff.). Indeed pressure from international markets, and in some cases the International Monetary Fund and European Commission, is forcing a number of countries

into pro-cyclical fiscal tightening, thereby exacerbating the crisis.

- In qualitative terms the packages were very mixed. On the positive side there was, in many countries, a focus on public investment (high multipliers). However, tax cuts were not sufficiently focused on low-income groups, thereby reducing the stimulus effect of any given tax cut; inadequate attention was paid to labour market policy and unemployment prevention, and to distributional concerns; and the chance to reorient production towards 'green growth' was largely missed (cf. Nikolova 2009).

**Figure 2.8 Estimated size of discretionary fiscal packages\*, (%GDP)**

	EU*	AT	BE	DK	FI	FR	DE	HU	IT	LU	NL	NO	PT	ES	SE	UK
Overall size of fiscal package	1.79	2.4	0.9	2.2	1.5	1	3	2	0.2		1			4.6	2.4	1.5
in 2009	1.02	1	0.4	1.2	1	0.7	1	0	0.2	1.75	0.45	0.75	1.2	2.3	1.25	1.4
in 2010	0.59	1.4	0.4	1	0.5	0.3	2	0	0.4		0.51				1.15	-0.1
revenue side	52	70	40	40	80	36	54				20			20	66	90
expenditure side	48	30	60	60	20	64	46				80			80	34	10

\* up to mid-2009

Data source: Watt (2009a).

## 2.2 Benchmarking the macroeconomic policy response

### Conclusion: macro policy in Europe partly to blame for performance

The analysis of this section points to a mixed picture for both European and national economic policy in response to the crisis in the EU. The disastrous errors of the Thirties were not repeated. But then the Great Recession happened after the Great Depression, and after Keynes and others had provided the analysis to understand it and the tools to deal with it. Policymakers had the tools, they ‘just’ had to use them (Watt 2008). To have repeated the hugely costly errors of the past would have been not simply foolish, but also criminal, and to that extent the current atmosphere of self-congratulation is misplaced. Perhaps the best that can be said is that policymakers were pragmatic. Faced with a possible total meltdown of the economy, they swiftly forgot all the theories of policy ineffectiveness and market rationality that had dominated debate for the past twenty or more years – and the truth of which they had repeatedly avowed. In that sense they deserve praise indeed. Ultimately, the actions taken were, broadly, of the right kind and the scale of action was impressive by historical standards. It certainly avoided much worse outcomes that would otherwise have been inevitable.

Yet the fact remains that Europe’s cumulative action remained far short of what was possible. As noted, Europe

experienced a deeper crisis than the US and this reflected, alongside some structural reasons, weaknesses in the policy response, as was shown above. In particular, both monetary and fiscal policy were initially slow to respond to the crisis, and neither went the ‘whole hog’ once the need for action was belatedly recognised. The problems of lost output, lost jobs and high fiscal deficits now faced by Europeans are worse as a consequence.

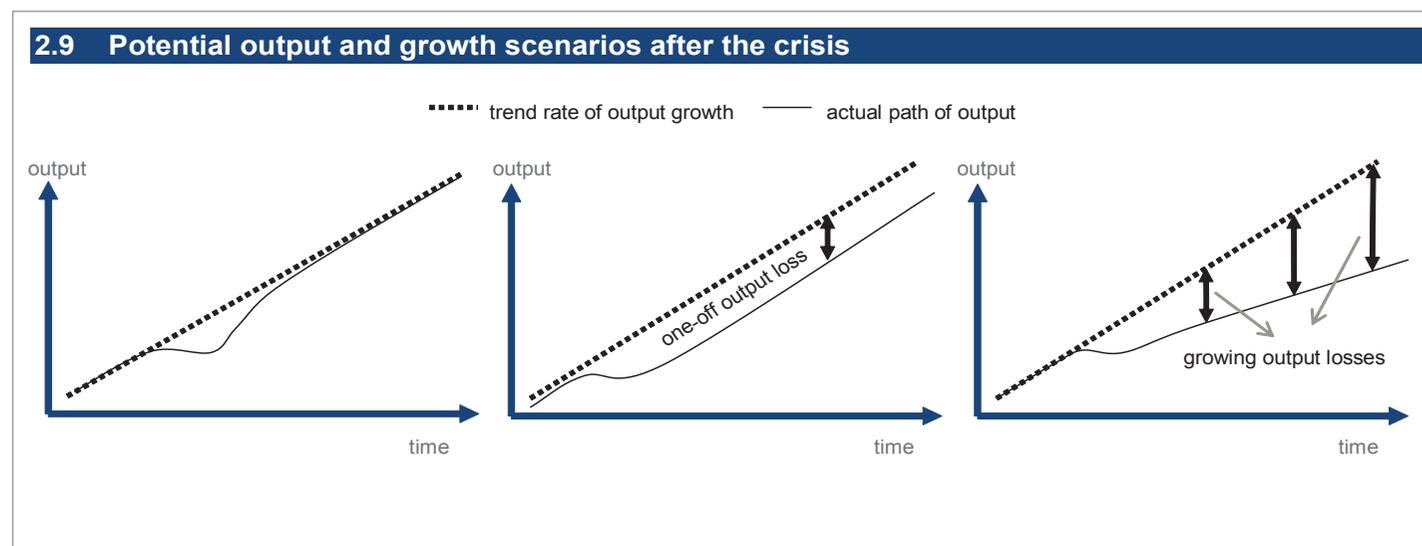
## 2.3 Looking ahead: how long-lasting will the impacts be?

### Potential output

The main aim of this chapter has been to examine the impacts of the crisis so far. Yet a number of concerns have been raised regarding the longer-term prospects. Two can be briefly addressed here. The first is that the sharp drop in output will have longer-term consequences on our economies' ability to produce in the future, in other words on the level of potential output and the rate of potential (non-inflationary) growth. The second is that the fiscal problems already described will deteriorate further (especially if growth is slower), leading to fiscal crises and/or the need for painful cutbacks in the levels of public provision.

Figure 2.9 provides a graphic illustration of possible outcomes of a crisis on potential output and growth. The economy is initially growing at a trend rate: this is the sloped line showing a steady increase over time, and the slope is the potential growth rate. At any point in time the economy is at its potential output: it is producing as much as it can without creating imbalances. The crisis causes output to dip. If the economy is to move back on to the previous trajectory it must enjoy a period of faster-than-trend growth (catch-up period), before returning to the previous rate. This is shown in the first panel. In the long run neither potential output nor growth are affected.

If this is not achieved the economy may, after a time, return to the previous potential growth rate, as in the second panel. In this case the loss of output due to the crisis is permanent, but also one-off. A much more worrying scenario is depicted in the third panel, where the crisis also depresses the rate of potential growth, which then never returns to what was previously normal. In that case the economy moves ever further away from its previous output trajectory.



## 2.3 Looking ahead: how long-lasting will the impacts be?

### Potential output

The debate is dominated by the last-mentioned, pessimistic case. Several arguments are adduced to support this view (cf. e.g. European Commission 2009f). It is argued that the crisis showed that growth prior to 2008 had been unsustainably fast, fed by excessively low interest rates, and will have to be slower in future; some economic sectors (automobiles, finance) have overcapacity and will have to contract in the coming years; higher regulatory costs in the financial sector and greater risk aversion by investors will both mean higher capital costs for investors, thereby depressing capital accumulation and thus potential output. Meanwhile job losses will lead to the lasting exclusion of workers from the labour market, and/or the loss of skills, reducing the quantity and quality of future labour input (so-called 'hysteresis effects').

Yet counter arguments can be made against all these claims: real economic growth was not unsustainably fast; it was asset and credit growth that suffered from a bubble; the necessary decline in some sectors can and should be balanced by the rise of others (e.g. producing 'green' technologies); higher capital costs can and should be offset by monetary policy; and finally, avoiding hysteresis effects is the task of labour market and also demand-side

policy. More generally, it is odd that those who have always insisted on the neutrality of money and the idea that demand is not important in the longer run now argue that the crisis can depress longer-term prospects (Horn *et al.* 2007; Watt and Janssen 2005).

The decisive point is that there are no grounds for fatalism. There are indeed *risks* of a longer-term depressing effect on potential growth rates. There is historical evidence that the impact of financial crises tends to be longer-lasting than that of other negative output shocks (Reinhart and Rogoff 2009). But, crucially, outcomes depend decisively on what policies are deployed. In particular, macroeconomic policies must bring the rate of demand growth quickly back to its previous rate and keep it there; this cautions against premature 'exit' strategies from expansionary policies. Otherwise, there is a real danger of self-fulfilling prophecies if a lower potential growth rate is assumed *ex ante*: the resulting tighter policies will then bring about precisely this result. In parallel, supply-side policies are also needed, among other things to manage change processes on labour markets, re-equip the unemployed with needed skills, and invest in industries of the future. In this context the labour-hoarding strategies practised by several EU countries (see

above) will have positive effects also in the longer run, to the extent that they maintain productive capacity, and especially workers' skills and labour market attachment.

## 2.3 Looking ahead: how long-lasting will the impacts be?

### Public finances

A number of dire predictions have been issued about the longer-term sustainability of EU public finances and, by extension, about the continued existence of Europe's 'generous' welfare states (von Hagen *et al.* 2009; European Commission 2009b). The concern is that high debt and deficits in the wake of the crisis interact with higher interest rates, more sluggish growth and, increasingly, the costs of ageing to produce a 'time bomb' for European public finances.

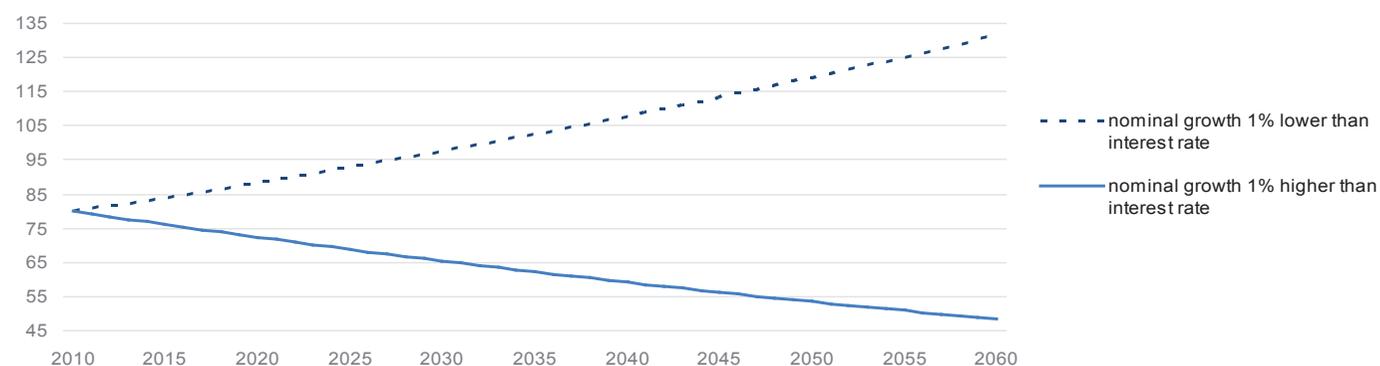
The key outcome of the Commission's analysis (European Commission 2009b: 3) is that, on unchanged policies and relying on its estimations for variables such as interest rates, growth rates, and demographic trends, achieving budget sustainability requires EU countries, on average, to raise revenues or cut expenditures to a combined value of some 6% of GDP. Roughly half of this is due to higher age-related spending, the other half being required to rectify the accumulated fiscal 'sins' of the past and the current crisis.

While a full discussion is not possible here, a number of key points are in order. The projections are over a long period (to 2060) and have to make simplifying assumptions about a whole range of specific factors, not least migration, life expectancy, etc.

The projections, it must be emphasised, are based on a 'no policy change' assumption, whereas measures are already being planned and implemented in Europe, notably to raise retirement ages. Two variables are absolutely critical for these analyses: the nominal interest rate on government debt and the nominal rate of GDP growth. Very small changes in these variables, over the projected period, lead to totally different outcomes. Specifically, whether the former variable is assumed to be greater than, equal to or smaller than the latter is decisive for the debt path, as the gap determines whether debt falls or rises as a share of GDP *even without fiscal consolidation*.

This is shown by Figure 2.10. Given the same fiscal policy – a zero primary balance, which actually means in practice a deficit in the region of 3% every year – a country moves from the forecast level of 80% of GDP in 2010 to more than 130% of GDP in 2060 if the nominal interest rate is 1% higher than the nominal growth rate. On the other hand, the ratio falls to below 50% if the interest rate is 1% below the nominal growth rate.

Figure 2.10 Simulation of government debt (as % GDP)\*



\* Assuming zero primary government surplus/deficit every year  
Data source: own calculation.

## 2.3 Looking ahead: how long-lasting will the impacts be?

### Public finances

Crucially, not only is there a margin of error in estimating these variables, but the interest rate and nominal GDP growth are, to a considerable extent, *policy* variables. (It should be noted that we are talking about nominal not real GDP, and thus price increases raise nominal GDP). Other things being equal, if the central bank keeps interest rates lower, the interest rate paid by government will be lower and the pace of nominal GDP growth will be higher. A positive gap opens up between growth and the interest rate, which as we have seen brings debt ratios down. Similarly, fiscal solidarity between EU governments (e.g. in the form of euro-bonds) would also reduce the interest rates faced by governments with high debts, and thus change a key parameter of the debt dynamics, facilitating fiscal consolidation. A critical weakness of the Commission and other analyses of the longer-term fiscal sustainability is either to remain unaware of or to deliberately omit to discuss such policy options.

That this is no mere abstract exercise is shown by the data in Figure 2.11. It is evident that for the EU15 countries during the 1990s and 2000s changes in the size of government debt as a proportion of GDP are closely related to the gap between the nominal interest and the growth rate. Periods in which

the debt burden rises as a share of GDP are those in which the interest rate is higher than the rate at which the economy is growing, measured in current prices, and vice versa. This is true using both the short-term interest rate (which is close to that determined by the central bank) and the long-term rate (which is more loosely related to the policy rate, but more decisive for government debt dynamics.)

Ultimately, a government with an independent currency and central bank need never get into an unsustainable position. As the issuer of legal tender it can always create the funds needed to pay bondholders. Of course the outcome

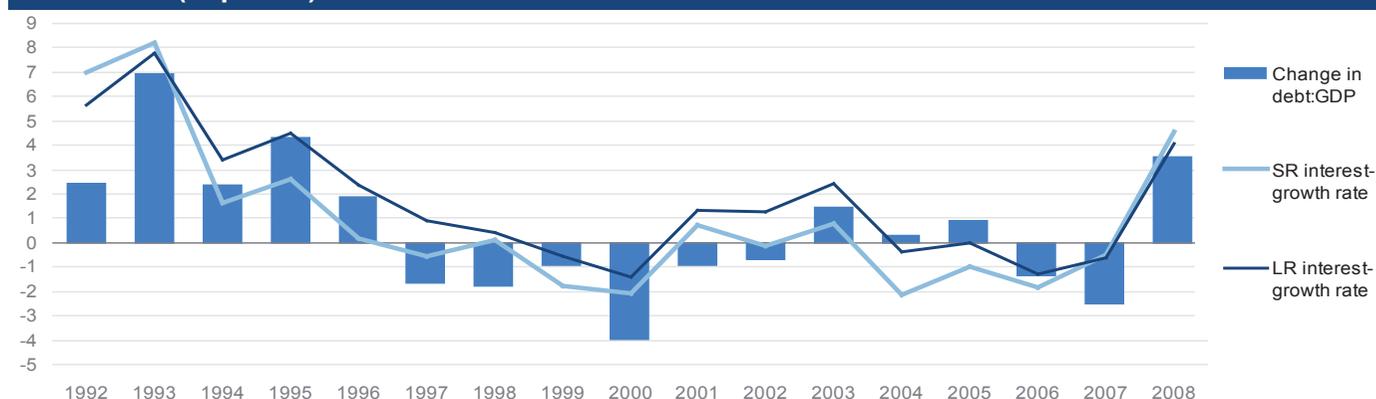
– inflation – is in itself undesirable. But then so are cuts in public services and a higher tax burden. Yet the implied trade-offs and the partial responsibility of monetary policy for fiscal sustainability are not being discussed.

Similar considerations apply to tax revenues. Many would argue that the costs of the financial crisis, for instance, should be as far as possible borne by the sector that was largely responsible (Watt 2009). A small rate of tax on financial transactions could generate large amounts of fiscal revenue (Schulmeister *et al.* 2008). The same is potentially true of tax coordination in order to prevent tax avoidance and

downward competition on taxation of corporations and top incomes and also of a carbon tax. Such discussions are also excluded from the Commission analysis.

If we are to have a debate on the sustainability of public finances it must be an open one in which the alternative courses of action are weighed in an impartial manner. While studies such as that of the Commission play a useful role in focusing minds on this important issue, they do the European public disservice by implicitly or explicitly channelling the debate in such a way as to favour certain policy options over others.

**Figure 2.11 Changes in government debt/GDP ratio and in nominal interest rate/growth differential, (% points)**



Data source: AMECO.

## 2.4 Conclusions

The economic crisis has left its scars on the European economy. Those scars will take a long time to heal, and may remain visible for decades to come. The European, and global, economy remains in a delicate state and extreme caution is required from policymakers before deciding to remove the current stimulus measures. The danger of a renewed downturn, with potentially catastrophic consequences, is still real. When so-called exit measures are implemented, attention should be paid to distributional and sustainability concerns. This suggests, in particular, the need for continued low interest rates, accompanied by initially cautious, but subsequently resolute, fiscal consolidation that places the burden on the 'broadest shoulders' and maintains public spending, especially investment in support of future economic activity faced with the challenges of climate change.

The main conclusions from the above analysis are that the European response to the crisis was a case of a 'glass half full' (or 'half empty' depending on one's preferences). Huge challenges remain to ensure a path back to steady growth and to solve the fundamental causes of the crisis (to address inequalities, imbalances between countries and inadequate regulation, especially but not only of the financial

sector). Major question marks have been raised about some of the central elements of the Maastricht architecture for economic policy in the EU and the euro area – the tasks of monetary policy, the Stability and Growth Pact, etc. At the same time, the euro appears to have weathered the crisis well – so far at least – and has shielded its members from damaging currency turbulence. Nevertheless, some tensions have emerged and the inability to devalue poses problems for some countries.

Precise policy recommendations are not made here. A forthcoming ETUI book entitled *After the crisis, towards a sustainable growth model*, sets out a range of progressive policy options for the future (Watt and Botsch 2009).