<u>The Economic Basket Case that is the Euro Zone</u>

Christopher Ragan
The Globe and Mail, October 7, 2014

Though the recession ended five years ago, our economy remains in a rut. Economic growth is sluggish, the labour market shows too much long-term unemployment, and exports are very far below normal. Our policymakers wait patiently for a solid U.S. recovery to pull us from the doldrums. But whatever problems we face in Canada, we should be grateful to be far away from Europe, where the situation is very much worse.

How much of an economic basket case is the euro-zone economy? Gross Domestic Product (GDP) is now 2 percent *below* its 2008 level. The average annual growth rate in the decade before the crisis was 2.1 percent. With that kind of upward trend, GDP in the euro zone is now 15 percent below what would likely have existed in the absence of the crisis.

Of course, not all countries in the euro zone are in the same predicament. Germany and France have shown intermittent but positive growth in each year since 2009. Italy, Spain and Portugal have all averaged negative growth rates, which is remarkably bad even by Canada's current low-growth standard. Even worse is the tragedy in Greece, where the economy has collapsed by over 25 percent in six years, which puts it within the ballpark of a Great Depression.

With slow growth or absolute GDP declines, unemployment in the euro zone is naturally very high, but again there are clear differences across countries. Germany's unemployment rate is a reasonably healthy 5.2 percent, but in France, Italy and Portugal the rates are 10.4, 12.6, and 14.6 percent, respectively. In both Spain and Greece, unemployment rates are above 25 percent of the labour force. In *every* one of these countries, more than 40 percent of the unemployed have been jobless for over one year.

This is the kind of economic performance, especially in Spain and Greece, which if sustained can lead to violent, social revolution. Policymakers and citizens, in Europe and elsewhere, should be very worried about how the euro zone will eventually rise from the ashes – or if it ever will.

There are many difficulties in the euro zone, and its policymakers certainly don't have an easy job. Yet we can still identify two large policy mistakes that have contributed enormously to the current situation.

The first has been the sustained drive for fiscal austerity across Europe. It is true that many countries had accumulated too much government debt by 2010, and in some cases they had gone way too far. But as damaging as high debt can be, there are times when fiscal austerity is simply the wrong thing to do. When the economy is collapsing and unemployment is soaring, the attempt to repair the government's books by cutting spending or raising taxes worsens an already bad economic situation and, by reducing growth, typically worsens the government's debt-to-GDP ratio as well.

Across the euro zone, the "structural" fiscal deficit – the one that would exist if the economy were operating at full employment – went from 4.8 percent of GDP in 2010 to 1.2 percent this year. This tightening of fiscal policy (by 3.6 percentage points) is partly responsible for the absence of GDP growth and the increase in the debt ratio by 15 percentage points.

The second major policy mistake, especially given this very tight fiscal policy, has been the failure of the European Central Bank (ECB) to provide a massive monetary expansion. In 2009, the U.S. Federal Reserve began "Quantitative Easing", the use of freshly created money to purchase massive quantities of government bonds and asset-backed securities. These actions injected money into the financial system, offset commercial banks' inclination to restrict lending, and helped to support the housing and stock markets. This has been an essential element of the emerging U.S. recovery.

The ECB, in contrast, has not engaged in this kind of large-scale asset purchases. Its President, Mario Draghi, has stated that the ECB stands ready to do whatever is necessary, but apparently the euro zone's current economic situation is not yet dire enough. One wonders what he could possibly be waiting for.

For a macroeconomist, it is depressing to watch 550 million people struggling so hard to get back on their economic feet – especially as the macro policymakers keep pushing them back down. If policies don't change soon, those on the ground may soon start picking up rocks.

*****

Christopher Ragan is an associate professor of economics at McGill University and a research fellow at the C.D. Howe Institute.