ASK NOT FOR WHOM THE BELL TOLLS

AFTER A RECENT RUN OF BAD NEWS, WHAT ARE THE ECONOMIC PROSPECTS FOR THE EUROZONE IN 2015? ALASTAIR WINTER OFFERS A DIAGNOSIS

The European Economic and Monetary Union (EMU) is unwell. And with no obvious, fast-acting antidotes, its prospects for the next few years are bleak.

The graph (opposite) shows the actual GDP growth of the EMU's four largest economies since the financial crisis alongside that of the UK and the US. It also reveals the European Commission's forecasts for GDP growth. Unfortunately, average annual growth of 0.2% over an eight-year period compares very badly with the 50-year average of around 3%.

The decline has been going on for longer than 2008, however, and not just in the eurozone. While the term 'secular stagnation' has been given a controversial new airing by US economist Larry Summers and others, there is no doubt the eurozone is experiencing a prolonged period of low growth in both aggregate demand and aggregate supply. With trepidation, I offer my case for secular stagnation in Europe.

The case for secular stagnation

Globalisation has led to greater equality of incomes and costs between (but not within) advanced and developing economies. This is a double whammy to the competitiveness of richer countries: their exports are still expensive while their imports have become less affordable. Trade suffers as a result.

Meanwhile, population growth in the eurozone is falling to a rate below 0.2% per annum and is already negative in Germany and Italy. And after being a significant contributor to growth through greater productivity over the past 20 years or so, the dividends offered by technology appear to have plateaued. Many jobs have been lost for good, however, and the next wave of technological revolution is shaping up to be even more dramatic. Any further productivity benefits may be offset by the redundancies of white-collar workers, as well as blue-collar workers.

Furthermore, governments and businesses are both investing less, if for different reasons. Governments are giving priority to current spending while business investment is held up by uncertain demand and the limited availability of funding.

The damaged banking sector is another concern. Contrary to the myths conveyed by eurozone leaders about Anglo-Saxon culpability, many European banks were heavily exposed to the sub-prime bubble as well as reckless adventures in Greece, Ireland and Eastern Europe. Domestic lending still seems a low priority for many, despite government exhortations and the largesse of the European Central Bank (ECB).

Unaffordable public services are a serious issue in the eurozone. The post-war European welfare state appears to have become an end in itself. This has been a long process, driven by the aspirations of politicians and voters alike. It is now clear that the previous rates of growth in current public spending are unsustainable. So far, Germany has led the way while the bailed-out countries have been obliged to embrace outright austerity. But, to date, France and Italy have been unwilling and unable to do more than merely slow down the rate of the increase in spending.

Finally, consumer confidence has collapsed. Faced with the prospect of job losses, pay freezes, welfare cuts, tax hikes and new and/or higher public service charges, it is no surprise that consumers across most income groups are reining back on their discretionary spending.

The outlook in 2015

So are things going to get better? Unfortunately, this does not look likely any time soon, and certainly not in 2015. And here's why:

- **Long-term unemployed. Many of these people may never work again. Just as shocking is youth unemployment, which stands at over 50% in Spain and Greece, and at more than 40% in Italy. It will take a decade or more of structural reforms and investment in training to reduce this burden, assuming optimistically that demand for labour eventually does pick up again.**
- **Productivity. This has been poor over the past eight years, even in Germany and France, where higher labour costs have stimulated more capital investment. The spectacular improvement in Spain has been achieved at the cost of higher unemployment and lower earnings. Italy seems to have the worst of all worlds.**
- **Earnings growth. Low growth is another trade-off against unemployment, notably in Spain and the smaller countries and, of course, it signifies less spending power.**

- **The consumer price index. Deflation has not yet taken hold and it should be distinguished from disinflation, which can be a good thing (for example, lower oil prices). Nevertheless, there are dangers. The higher real levels of earnings, interest rates and the value of debt can lead to worker layoffs, delayed consumer purchases and a reluctance by businesses to borrow to invest.**
- **Retail sales. These are clearly depressed at present.**
- **Industrial production. This is caught in a vicious circle of lower demand, leading to lower supply.**
- **Private-sector debt. This is at levels high enough to deter anxious consumers from spending and businesses from investing.**
- **Capital formation. Acquiring capital is a worrying sign that business sees little scope for expansion in the next few years.**
- **Government borrowing. The Fiscal Compact sets a target of 60% for the public debt/GDP ratio for each eurozone country. Even if exceptions are allowed, the going will be slow and painful. Research from the International Monetary Fund has suggested that the (negative) fiscal multiplier of public spending cuts on GDP is almost two.**
- **Ease of doing business. There are only six other eurozone countries joining Germany in the top 30 easiest countries in which to do business and all of them are small, including Finland (9), Ireland (13) and Portugal (25).**

With challenges like these, politicians and central bankers need to face up to secular stagnation and stop pretending that it is 'merely' cyclical. It will take time for the required blend of corrective measures to work. Eurozone leaders are unrivalled in their ability to fudge apparently irreconcilable positions, but they will be tested to the full in 2015.

So which options are open to them?

1. Structural reforms

The most commonly cited structural reforms relate to the labour markets, for example, flexibility on hiring and firing, reducing employer costs and enabling training/retraining as job requirements change. The banking sector also needs a lot of attention, but at least the ECB's asset quality review exposed a lot of the sector's problems (notably in non-performing assets) even if the associated stress tests were a damp squib. Restrictive professional practices that affect professions ranging from lawyers to pharmacists to taxi drivers are another major barrier to growth. Then there are shop opening hours, complex tax codes and even the red tape involved in setting up a new business. The list is long, the obstacles large and the hard work has barely started.

2. Monetary policy

It is important to remember that the ECB was not designed to deal with stagnation, but rather to enforce German rectitude on inflation. ECB president Mario Draghi now seems to be seeking a shoot-out with the Bundesbank and the German government, but it may not just be about purchasing sovereign bonds. It is far from clear that quantitative easing (QE) would achieve much, since its main benefit appears to be providing liquidity to prevent meltdown in financial markets and Europe is currently awash with liquidity. It is, moreover, questionable whether new cash from QE would rapidly flow into lending by banks and spending by consumers or investment by business.

3. Fiscal policy

It is understandable that the French and Italian governments are refusing to toe the line on 3% annual budget deficits. They face powerful unions and wider voter opposition. Meanwhile, the direct and indirect cost of strikes and social upheaval could be severe. Moreover, investors have an almost infinite appetite for sovereign debt, albeit they might expect higher yields. The key is to win popular support for national budgets that restrict current spending in favour of investment.

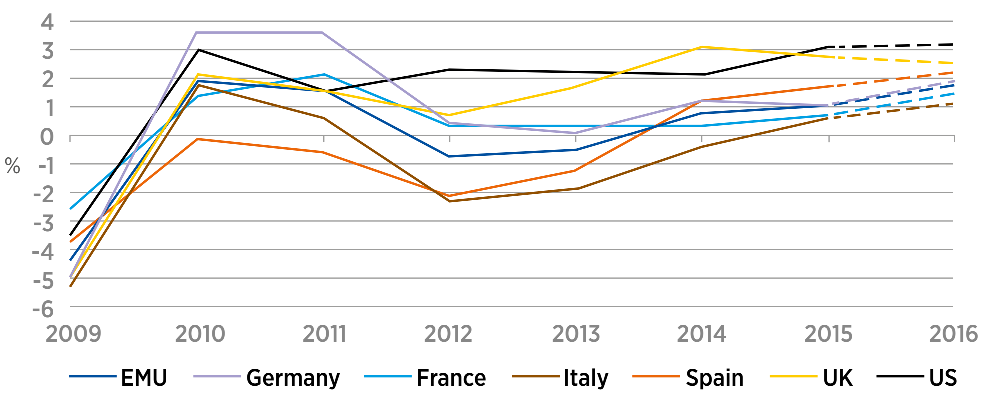
4. Euro exit/break-up

A unilateral exit could be costly, involving capital controls and unfavourable rates for legacy debts without boosting exports. An orderly break-up would also be disruptive, but still preferable if the Germans and French cannot agree on a common fiscal approach, including eurobonds and other transfers. The Germans may also find it legally, as well as politically, impossible to support further monetary easing.

Summing up

Representing 18% of world output, the eurozone remains (just) the planet's largest trading block. Its travails affect us all and *schadenfreude* seems especially malapropos. No guesses needed, therefore, for whom the bell tolls.

GDP GROWTH OF THE US, THE UK AND EMU'S FOUR LARGEST ECONOMIES



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