The case for using public investment to boost growth in the Eurozone is overwhelming

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Growth in the Eurozone has stagnated recently, generating fears that Europe could be heading toward another economic crisis. **Harald Sander** *writes on three explanations for the lack of a recovery in the Eurozone. He argues that the focus on balancing budgets and pursuing structural reforms has clearly failed to revive Eurozone economies and that a large public investment initiative offers the most logical solution under the present circumstances.*

One year after the Eurozone's much hyped 'recovery', signalled by some green shoots in the second quarter of 2013, the region's quarterly economic growth is flat again. Even Germany's growth prospects have been revised downward, and recent IMF estimates point to an almost 40 per cent chance of recession for the Eurozone. The main reason is the lack of determination of policy makers to end the Eurozone crisis. Will they continue to muddle through and pave the way for decades of low growth? Or will governments and the European Commission do 'whatever it takes' and change the fiscal stance as demanded recently also by ECB president Mario Draghi?

Three explanations for the missing recovery

Three narratives for the missing recovery are dominating the current political and academic debates. The first – told by austerity-favouring countries – holds that structural reforms are showing initial positive results in most of the southern Eurozone countries, while France and Italy are still lagging behind. However, the backlash in growth is mainly attributed to external events such as the crisis in the Ukraine and the Middle East, and the slowdown of growth in emerging economies, especially China. According to this view, staying on course with the reform agenda, alongside some modest fiscal stimuli that will not put the balanced-budget fundamentalism of Germany and others in jeopardy, would thus be sufficient.

The second narrative highlights the role of high private and public debts, which have continuously increased rather than decreased relative to the size of Eurozone economies since the crisis started. In other words, this view stresses that the structural-reform-cum-austerity strategy has even failed in its own core ambition. As a recent report shows, deleveraging has not yet begun. In this reading, the Eurozone is facing a balance sheet recession, which will only be over when balance sheets are repaired and especially banks and the public sectors have returned to sustainable debt levels.

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Unfortunately, this requires policies, which are difficult to adopt. Debt reduction schemes run counter to moral considerations of some governments and their electorates. They also risk financial contagion as they can feed speculations on debt cancellation elsewhere. And the self-interest of lender countries reinforces the resistance. The alternative is – of course – inflation to reduce the real value of debt. Strongly advocated by many Anglo-Saxon economists it meets equally strong resistance on the continent, naturally by savers and lenders. Thus, as argued by Richard Koo, democracies with strong savers find it difficult to implement policies to deal effectively with balance sheet recessions.

The third interpretation goes even deeper and views the current crisis at least in part as a consequence of a 'secular stagnation': a term and a debate re-introduced to the profession by Larry Summers in late 2013. According to the hypothesis, this 'SecStag' may have already begun some 20 years ago, especially in the most advanced countries. Their inability to find sufficient investment possibilities, coupled with falling prices for investment goods, can create an excess of savings, especially when income distribution is increasingly favouring high-income earners with a high propensity to save. This setting could theoretically drive down inflation-corrected real interest rates below zero. With a given lower-zero bound to nominal interest rates this would require inflation rates, which we may not be able to obtain due to a lack of demand in underinvesting economies. Thus, full employment may not be reached and secular stagnation becomes a real threat.

However, secular stagnation is difficult to prove, not least because it may have been masked by the dot-com bubble, loose monetary policy and financial de-regulation. The Eurozone may have covered its 'SecStag' problems in its own way. Northern economies in particular such as Germany, with high savings ratios and investment ratios as low as 17 per cent of GDP, have escaped low groth in the second half of the last decade by means of an enormous trade surplus. This was enabled by a massive reduction of unit labour costs vis-à-vis southern Eurozone countries. In this way, the savings of the surplus countries have been channelled through a rapidly integrating Eurozone banking system towards the periphery.

As such, the secular stagnation-interpretation of low growth does not contradict the balance-sheet recession view, but points additionally to deeper underlying causes. If correct, this narrative suggests that cleaning-up the balance sheets, though necessary, may not be sufficient to exit the low growth phase. If inflating is not politically feasible, public investments are an obvious candidate to fill the savings-investment gap.

One solution: public investment

Clearly, the current policy mix of austerity and structural reforms has failed to revive the economies and bring down the debt overhangs. Debt reductions and inflating have their own technical, economic and political problems. Thus, the policy of choice, which is compatible with all three narratives, is boosting public investment. With long-term real interest rates currently around 1 per cent, public investments are more than self-financing even when no additional secondary growth effects are assumed, thus offering a free lunch. The case for a public investment initiative is therefore overwhelming and also strongly promoted by the IMF.

How could such a solution be achieved? Public investment initiatives are needed at both the regional and the national level. At the European level, the proposed 300 billion euro public investment programme by the new European commission makes perfect sense. Details are still unknown, but a few points are worth being emphasised. First, fast and effective implementation is vital. Second, priority areas are clearly the energy sector (also as a response to the geopolitical situation), pan-European infrastructure, and education. Finally, financing is key and debt financing is entirely appropriate at the current level of long-term interest rates. Issuing European Investment Bank bonds are the obvious choice and could constitute good instruments for quantitative easing policies, if required.

At the national level, countries with fiscal space should boost infrastructure investment, too. If there is a country likely to face secular stagnation while at the same time having fiscal space, it is Germany. The German economics institute DIW estimates a long-term investment gap of 3 per cent of GDP and advocates massive investments in infrastructure.

Countries with critical financial situations should be given more flexibility with respect to the Stability and Growth Pact when redirecting public spending towards investments. This would correspond to the former German "golden rule", which allowed credit finance of public investments. In the longer term, rather than a flexible interpretation, a more realistic and economically sensible fiscal compact is needed. Only a realistic pact that will and can be adhered to by all countries will ultimately create the confidence the Eurozone needs.

While economically the case for public investment is crystal clear, policy makers need now to find ways to communicate to their electorates that it is time to change both faulty narratives about the Eurozone crisis, debts and deficits, and faulty policies.

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