



The Eurozone's Hidden Strengths

Daniel Gros

For years, the eurozone has been perceived as a disaster area, with discussions of the monetary union's future often centred on a possible breakup. When the British voted to leave the European Union last year, they were driven partly by the perception of the eurozone as a dysfunctional and possibly unsalvageable project. Yet, lately, the eurozone has become the darling of financial markets – and for good reason.

The discovery of the eurozone's latent strength was long overdue. Indeed, the eurozone has been recovering from the crisis of 2011-12 for several years. On a per capita basis, its economic growth now outpaces that of the United States. The unemployment rate is also declining – more slowly than in the US, to be sure, but that partly reflects a divergence in labour-force participation trends.

Whereas labour-force participation in the eurozone is on the rise, it has been declining in the US since around 2000, and especially after the recession of 2009. The departure of Americans from the job market reflects what economists call the “discouraged worker” phenomenon. And, indeed, the trend has accelerated since the latest recession.

In principle, declining labour-force participation should be a problem in the eurozone too, given the prolonged period of very high unemployment that many European workers have faced. But in the last five years, 2.5 million people in the eurozone have actually joined the labour force, as 5 million jobs were created, reducing the decline in unemployment by half.

Moreover, the eurozone recovery has been sustained, somewhat unexpectedly, even in the absence of continuous fiscal stimulus. The heated discussions about austerity of the last few years were misplaced, with both critics and official cheerleaders overestimating the amount of austerity applied over the last three years. The average cyclically adjusted fiscal deficit has been roughly constant since 2014, hovering at around 1% of GDP.

Of course, large differences in the fiscal position of individual member states remain. But this is to be expected in such a diverse monetary union. The truth is that even France, often considered a weak performer, has deficit and debt levels comparable to those of the US.

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A comparison with the US, as well as with Japan, also undercuts the common perception that the eurozone's fiscal rules, including the (in)famous Stability and Growth Pact and the 2012 "fiscal compact", have been irrelevant. True, no country has been officially reprimanded for excessive deficits or debts. But the clamour over rule breaches at the margin have overshadowed the broad underlying trend towards sound public finances that the fiscal rules have fostered. All of this suggests that the 'soft austerity' pursued in many eurozone countries may have been the right choice after all.

To be sure, one should not overestimate the eurozone's long-term economic strength. While the average growth rate might remain above 2% for the next few years, as the remaining unemployed are absorbed and the long-term trend of older workers re-joining the labour market continues, the pool of unused labour will eventually be exhausted.

Once the eurozone has reached the so-called "Lewis turning point" – when surplus labour is depleted and wages start to rise – growth rates will fall to a level that better reflects demographic dynamics. And those dynamics aren't particularly desirable: the eurozone's working-age population is set to decline by about half a percentage point per year starting with the next decade.

Yet, even then, the eurozone's per capita growth rate is unlikely to be much lower than that of the US, because the difference in their productivity growth rates is now minor. In this sense, the eurozone's future may look more like Japan's present, characterised by headline annual growth of a little over 1% and stubbornly low inflation, but a growth in per capita income similar to that of the US or Europe.

Fortunately for the eurozone, it will enter this period of high employment and slow growth on sound footing – thanks, in part, to that controversial austerity. In contrast, both the US and Japan are facing full employment with fiscal deficits higher than 3% of GDP – about 2-3 percentage points higher than those of the eurozone. The US and Japan also have heavier debt burdens: the debt-to-GDP ratio stands at 107% in the US and more than 200% in Japan, compared to 90% in the eurozone.

There is evidence that in the wake of a financial crisis, when monetary policy becomes ineffective – for example, because nominal interest rates are at the zero bound – deficit spending can have an unusually strong stabilising impact. But there remains a key unresolved issue: once financial markets have normalised, will maintaining a deficit for a long time provide continuous stimulus?

The fact that the eurozone's recovery is now catching up with that of the US, despite its lack of any continuing stimulus, suggests that the answer is no. Indeed, the experience of the eurozone suggests that while concerted fiscal stimulus can make a difference during an acute recession, withdrawing that stimulus when it is no longer vital is preferable to maintaining it indefinitely. With austerity – that is, reducing the deficit, once the recession has ended – it might take longer for the recovery to become consolidated. But once it is consolidated, economic performance is even more stable, because the government's accounts are in a sustainable position.

A few years ago, several prominent economists¹ and even experts from international institutions argued that austerity could be self-defeating. The argument was that cutting the deficit would reduce demand and thus GDP so much that the debt-to-GDP ratio could increase even if the deficit increased. In an earlier CEPS Commentary published in 2011, the present author argued that “austerity was unlikely to be self-defeating” in the long-run because in the long run output and employment will be independent of short-run changes in fiscal policy. A reduction in the deficit might depress GDP and thus the debt/GDP ratio initially, but most models suggest that these negative effects should fade out and reverse within a few years. Thus, the conclusion from several years ago seems to have been vindicated: “Implementing credible austerity plans constitutes the lesser evil, even if this aggravates the cyclical downturn in the short run.”

¹ See Paul Krugman, “Self-defeating Austerity”, *New York Times*, 7 July 2010 (<https://krugman.blogs.nytimes.com/2010/07/07/self-defeating-austerity/>), Dawn Holland and Jonathan Portes, “Self-Defeating Austerity”, VoxEU, 1 November 2012 (<http://voxeu.org/article/self-defeating-austerity>) and Jonathan Portes, “Is austerity self-defeating? Of course it is”, VoxEU, ND (<http://voxeu.org/debates/commentaries/austerity-self-defeating-course-it>).