Centre for European Reform

Rocky road back to growth

by Simon Tilford, 14 December 2009

There is no doubt that governments had to take exceptional steps in response to the financial crisis. Without such unprecedented action, many economies would have slipped into slump and probably deflation. With both public and private debt levels so high, deflation would have been crippling. But the point is approaching where stimulus and other monetary measures could become counter-productive. New asset price bubbles are inflating and there are signs of a return to excessive risk-taking in the financial markets. Fiscal positions are now terribly weak in many European countries. Deficit spending on this scale risks depressing rather than simulating economies, if investors lose faith in the sustainability of countries' fiscal positions and borrowing costs rise.

However, although there is no option but to start exiting soon, no-one should be under any illusions about the economic outlook. The short to medium-term looks bleak. Banking crises are typically followed by deep downturns and sluggish recoveries. This is no exception. Investment risks being held back by enfeebled banks. It is imperative that losses are disclosed and banks recapitalised. This is happening too slowly. Household borrowing is already high in many member-states and this will inevitably constrain private consumption. Cuts in public spending will soon be a drag on economic growth across most of Europe. Nor will external demand come to the rescue, not least because the euro looks set for a period of serious overvaluation.

Over the medium to long-term, the only way of bringing about sustainable economic expansion in Europe will be by boosting productivity growth and increasing employment rates. This demands markets that combine high skills and flexibility. Some European countries have one or the other; some neither; very few both. It demands an improved climate for innovation. A genuinely single market for high-tech products and pan-European capital markets would help high-tech firms to expand. Governments also need to increase public support of both pure and applied research as well as product development. Europe needs to learn from the US, where public procurement of one sort of another has made to the fostering of new technologies. Europe needs more, not less, competition. Without it, resources will be slow to move from underperforming or declining sectors to faster-growing, higher-tech ones. Finally, the financial system needs to allocate capital to those that can employ it most productively. The last few years suggest that financial markets are a long way from being perfect at doing this. But they are surely still better than governments.

However, governments will find it hard to implement many of these measures. One of the most striking trends of recent years has been rising inequality. Falling demand for unskilled labour is one reason for this. However, there is more to it. The rewards of economic growth have been accruing disproportionately to the rich rather than to skilled labour in general. Board-room pay is still rising rapidly across Europe, inflating wage differentials. This is not just a trend specific to the financial sector problem and it is certainly not confined to member-states that are considered to be 'economically-liberal'. Moreover, to a greater or lesser extent, governments have also had to step-in to bail-out the financial sector, and hence in the process some of the most highly rewarded people in Europe.

These developments threaten to be poisonous for the political economy of reform. Governments will have to do a number of things if they are to succeed in restoring order to public finances and in pushing through further reforms of labour and product markets. They will have to ensure that the burden of public spending cuts and tax increases is borne equitably. They must do a much better job of demonstrating how greater EU integration and reform benefits the average worker. And they will have to address the issue of excessive pay, both in public and private sectors. If they fail to address these problems, they will have a hard time cutting spending and pushing through tax increases. And they will struggle to pass anything that looks like a 'supply-side reform'.

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