Europe’s ‘long-Covid’ economic frailty

Adam Tooze 25 January 2021

Last year’s agreement on an EU recovery package was widely celebrated. This year its inadequacy will sink in.

The attention of the European public is with good reason focused on the pandemic and the need to accelerate the rollout of the vaccines. But other risks lurk ahead.

Since last summer a bubble of complacency has surrounded the European Union’s recovery package and the vision it holds out of a greener future. Europe’s constructive response to the crisis contrasts pleasingly with the dark political drama played out on the other side of the Atlantic. But 2021 may bring disillusionment, as the frailty of Europe’s economic position is once again exposed.

Innovative package

The achievements of the EU in responding to the social and economic fallout from the crisis are real. In 2020, thanks to intervention by the European Central Bank, it avoided a return to a sovereign-debt crisis. July saw preliminary agreement on the innovative Next Generation EU package.

That deal was confirmed in a diplomatic cliffhanger at the December meeting of the European Council. It is remarkable that, in the midst of the crisis, the EU managed to establish a new fiscal capacity and remain focused on its Green Deal.

Europe also managed to contain the worst social effects of the coronavirus crisis, through dramatic extension of the short-time working model. Despite a huge hit to hours worked, Europe avoided the labour-market disaster suffered by the United States.

But, for all these creditable achievements, we should not ignore the conclusion that screams out of year-end assessments, by the Organisation for Economic Co-operation and Development, the International Monetary Fund and the European Investment Bank.

Economic damage

By virtually every measure, the recession in Europe in 2020 was far worse than that suffered by the US and the policy response less adequate. Unless the steps taken last year are followed by new and even larger efforts, Europe’s prospects look grim.

According to the OECD, in 2020 euro-area gross domestic product fell by 7.6 per cent. Far worse than the setback suffered in 2008-09 or the worst years of the eurozone crisis, that is also far worse than the US, where GDP contracted by 3.5 per cent in 2020. One can argue about trade-offs with regard to lockdowns but then Europe has little to celebrate on the public-health front either.

While Brussels was feting Next Generation EU, gross fixed-capital formation in the euro area fell by more than 10 per cent, compared with 'only' 1.7 per cent in the US. To put that in round figures, the European Commission and the EIB estimate that the shortfall in private investment will come to €831 billion in 2020 and 2021—greater than the offsetting recovery package. It should be particularly concerning that investment slumped most severely in southern Europe, which has been suffering chronically low investment since 2010.

Another indicator of the weak state of demand is the deflation afflicting the euro area since September. Were this to become chronic, it would stifle investment: deflation punishes those who borrow to invest.

Not sufficient

To counter the slide, the ECB has pulled many of its policy levers. Thanks to its asset purchases, every sovereign in Europe can borrow, as other sovereigns all over the world, at record low rates. But though avoiding a sovereign-debt crisis is the necessary condition of a recovery, it is not sufficient.

A telltale sign of the depressive forces at work is the strengthening of the euro against the dollar. This is not a bet by global investors on the relative strength of the European economy—rather the reverse. Holding euro rather than dollars is attractive because in the US inflation is expected to pick up soon, to a relatively healthy 2 per cent. There is little prospect of that in the euro area.

The conclusion is inescapable. For all the commendable determination to avoid the mistakes of 2010, the ECB, Europe's governments and the commission have not done enough to avoid a very serious setback to the European economy—in absolute and, more tellingly, in relative terms.

Yes, the fiscal rules were promptly loosened. Yes, in some EU countries, notably Germany and Austria, the fiscal response was substantial. But the problem is that in the financially weakest parts of the eurozone the stimulus was nowhere near big enough—particularly Spain but also Italy, which according to some estimates faces a yawning, 10 per cent gap between potential and actual output.

Hard assessment

Assessing the size of the discretionary fiscal impulse—the bit of the deficit that is down to changes in policy as opposed to the operation of automatic stabilisers such as unemployment insurance—is hard under any circumstances. It depends on making assumptions about what a fully-employed economy would look like. When faced with an unprecedented shock, this is particularly tricky. But according to the OECD, the discretionary fiscal boost delivered by the euro area in 2020 was no more than half that in the US.

Admittedly, the US had to do more because its welfare system is so fragile: unemployment benefits are uneven and inadequate. Facing a genuine social crisis, Congress delivered two giant stimulus bills, running to $3.5 trillion all told. The new administration under Joe Biden promises more to come.

Allowing for differences in labour-market outcomes and social transfers, perhaps the most telling indicator, in the final analysis, is disposable household income. Remarkably, despite a huge surge in unemployment, in 2020 disposable income actually went up in the US. *Ad hoc* government transfers more than compensated for the labour-market shock. By contrast, across the EU, disposable income fell—by more than 3 percent in Belgium and Greece.

Unanswerable case

No one would advocate the US model as an alternative. But the case for Europe doing more is unanswerable.

The ECB is moving, discreetly, in a Japanese direction, targeting interest rates and spreads. That eliminates the risk of panic, which is a huge relief. But it will not by itself restore growth. More 'targeted longer-term refinancing operations' lending to European banks might help. And there may be an argument for even more adventurous use of dual interest rates to incentivise further lending.

But what Europe needs most of all is a second big fiscal push. And this is where complacency is most problematic. The Next Generation EU flagship is undoubtedly a political triumph—but economically it is simply not big enough.

IMF economists have bravely tried to estimate the impact of the programme on euro-area growth. Making all sorts of optimistic assumptions, it is possible to imagine that it may close half the gap in GDP growth, relative to the pre-crisis trend. On more realistic assumptions, it will cover less than a quarter.

Outlook depressing

On current fiscal settings, the outlook for the European economy is nothing short of depressing. According to the OECD, at the end of this year, euro-area GDP will still be 3 per cent down on 2019. That is a €360 billion chunk removed—roughly the size of the economy of Denmark.

By contrast, by the end of 2021 the US will probably be fully recovered. China will be close to 10 per cent ahead of where it was at the end of 2019. Even slow-moving Japan will recover more quickly than the EU.

It is not until 2022 that euro-area GDP is expected to regain its 2019 level. And not everyone will recover at the same pace. Germany, the European champion, is expected to be 1.5 per cent ahead of where it was at the end of 2019. That is miserable, by any standard, but the Germans will count themselves fortunate: at the end of 2022 the OECD expects Spain's GDP to be 3 per cent down on its pre-crisis level.

And the real concern should be Italy. Italy's economy has been on a downgrade for more than a decade and 2020 knocked it back even further. As things stood in quarter three, GDP was 10 per cent below where it was in the first quarter of 2008.

Growth is not everything. Social security is important. The environmental agenda demands a new model of growth. The EU's Green Deal is a step in the right direction.

But if Europe fails to deliver prospects, not just for the 'next generation' but this one, it should not be surprised if the optimism associated with the political achievements of 2020 soon wears thin.

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