Europe's economic dilemma

By Martin Feldstein
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The European Central Bank deserves credit for the economic improvements that have occurred in the past few years. But the ECB's policies also mean that the eurozone has no ammunition left to fight the next recession, because interest rates cannot be reduced further and fiscal policy remains in the hands of national governments.

Europe faces a serious problem. Although economic activity has recently increased, the eurozone has lost the ability to respond to the next downturn when it happens, as it inevitably will.

The European Central Bank deserves credit for the economic improvements that have occurred in the past few years. In a speech at the annual gathering of central bankers in Jackson Hole, Wyoming, in 2014, Mario Draghi, the ECB's president, explained that three things could improve economic performance in Europe:

- fiscal expansion by the country that had the capacity to do it (Germany);
- structural reforms in Italy and France;
- a change of monetary policy.

But Draghi went on to predict that Germany would not create a fiscal deficit and that Italy and France would not undertake the needed structural reforms. He concluded that the ECB would have to stimulate growth by reducing interest rates, which would increase net exports by creating a more competitive euro.

The ECB has since taken the short-term interest rate into negative territory, cutting it from 0.2% in August 2014 to -0.3% now. The ECB also bought long-term bonds for its portfolio, increasing the volume of its holdings from €2.2 trillion ($2.6 trillion) in 2014 to more than double that amount now. The euro-dollar exchange rate fell from $1.39 in 2014 to a low of $1.04 in 2016, before recovering to the current level of $1.18. The ECB's negative-interest-rate policy also stimulated business investment and other spending that is sensitive to borrowing costs.

But the ECB's policies also mean that it has no ammunition left to fight the next recession, which could be caused by a collapse of asset prices, starting with the price of long-term bonds. German ten-year bond prices are extremely high, reflecting a current yield of less than 0.5%. A fall in US stock and bond prices, which are also out of line with past experience, could cause European asset prices to decline in sympathy.

Alternatively, European exports could fall in response to geopolitical events in Asia or the Middle East, depressing overall economic activity in Europe. An end to the US expansion, now in its ninth year, could pull down demand in Europe. Although the US economy is now performing very well, the excessive level of asset prices – the result of a decade of near-zero interest rates – poses a threat to stability.

Whatever the cause of the next downturn, ECB policies that helped in the past would no longer be available. The conventional response – reducing interest rates – is impossible, because current short-term interest rates in the eurozone countries are already near zero or negative.

To be sure, the ECB could expand its purchases of long-term bonds. But doing so would not have the same effect that it did in the past. One of the goals of large-scale bond purchases – so-called quantitative easing – was to drive down long-term interest rates in order to stimulate business investment and housing construction. But with long-term interest rates now close to zero, bond purchases would not be able to lower them any further.

Another goal of lowering the yield on long-term bonds was to stimulate demand for equities. Higher stock prices would lower the cost of equity-financed business investment and increase household wealth, thereby stimulating consumption. This was never as successful in Europe as it was in the United States, where share ownership is more widespread. But now, with long-term bond yields already close to zero, it could not even be tried.

In short, the ECB would be unable to respond to an economic downturn by lowering interest rates and buying long-term bonds. And without the ability to reduce interest rates, the ECB also would be unable to stimulate net exports by reducing the value of the euro.

Whereas the US could respond to a new downturn with fiscal stimulus, it is difficult to see how this could be achieved in Europe. The eurozone has no fiscal authority. Each member country could of course reduce taxes and increase spending. But much of the stimulus would spill over to the country's trading partners through increased imports. The result would be an increase in the country's national debt with relatively little increase in its domestic demand.

An appropriate response to this dilemma may be a policy of coordinated fiscal expansion. Each country would have to agree to a combination of tax cuts and increases in government spending scaled to the size of the economic downturn. Waiting until the downturn occurs to plan this coordinated response would be a mistake. All eurozone governments should place fiscal coordination with their European partners high on their agenda, before it is too late.

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