Too late to do too little

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In a recent blog post, we reviewed the euro area's policy response to its unrelenting crisis. In mid-2010, instead of needed stimulus and healing, euro area authorities adopted a patently unproductive one-speed fiscal austerity. That legacy renders the task ahead more daunting than generally appreciated.

The fiscal austerity between mid-2010 and 2014 was unprecedentedly high. True, the public debt-to-GDP ratios were rising and needed a response. Even so, the degree of austerity was a huge step up from the euro area's own history and was significantly higher than that in other advanced economies during these years. Although less intense in 2015, the embedded austerity will have a lingering impact.

The austerity was particularly damaging because it was not accompanied by adequate and timely monetary policy stimulus or by actions to rehabilitate the banking sector. The U.S. Federal Reserve had lowered the policy interest rate to zero and embarked on the first round of quantitative easing by the end of 2008; the European Central Bank (ECB) brought interest rates to zero only in mid-2014, and the hand-wringing on quantitative easing continues. The United States also largely dealt with its banking problems by 2010. Despite self-congratulatory claims on the "progress" of the banking union, few concrete actions have taken root so far—optimism is based on the hope of change. And the U.S. took modest policy steps to alleviate personal debt burdens.

The unthinking response in every euro area country was more austerity. For example, the Netherlands, which had a low public debt-to-GDP ratio, undertook austerity with the same vigor as Italy, where the debt ratio was much higher. The Dutch austerity was unambiguously bad policy. Because Dutch households carry very high debt burdens, a widely-held consensus is that a strong fiscal stimulus was required. The logic is straightforward. Higher incomes made possible by the stimulus help reduce debt burdens, which, in turn, frees up household spending. Together, the stimulus and lower household debt help improve growth prospects. Today, Dutch policymakers need to tackle higher public debt than in 2010 and undiminished private debt.

Austerity has had a double effect: by importing less from each other, the eurozone nations have dragged each other down.

Yes, austerity eventually helps to reduce debt burdens. But that takes time. GDP growth was, however, reined in immediately. For this reason, public-debt-to GDP ratios continued to increase after fiscal euro area austerity was launched. The authorities reacted by stepping up austerity, further damaging growth. Nearly four years after the launch of unprecedented austerity, the public debt ratios are higher in almost all euro-area countries than they were in 2010.

And now some countries are entering a distress zone from which pulling back is especially hard. Not only have debt ratios increased, they also have risen faster than anticipated. Countries such as Italy that have experienced the largest unforeseen rise in debt ratios are also those with the strongest tendencies for price deflation. In other words, unwavering austerity failed to rein in debt but, by weakening demand, it may have triggered a deflationary process in the most stressed economies.

Reversing a debt-deflation cycle is the most difficult macroeconomic policy challenge. Measures to reduce debt tend to reinforce deflation. As a consequence, the ability to repay the debt declines, but the value of the debt obligations does not. Hence, debt reduction measures become powerless, and the debt burdens can pile up.

The eurozone is especially ill-equipped to deal with this inherently difficult problem because the policy framework only allows for a one-size-fits-all policy approach. Monetary policy is the same for all countries and cannot address individual country stresses. And the latitude in fiscal policy is limited because a substantial stimulus is out of bounds and there are no sources of fiscal transfers to alleviate the country distress. But such a one-size-fits-all framework cannot work because the nature and magnitude of the challenges faced by countries is vastly different. A country-specific policy approach is needed—and the euro area has no tools for that purpose.

The simple truth is that, while the panic has abated, the eurozone economy faces a worse medium-term growth, debt, and deflation outlooks than at any time since the start of the crisis. A Japanese-style lost decade may be the happy outcome.

At their “unemployment summit" in Milan on October 8, the leaders no doubt discussed the range of “flexibility” offered by the fiscal rules and possibly the relief that would be provided by the ECB’s promised actions. Movements along these margins will continue to disappoint. Much bolder action is needed than is being contemplated. As the Irish economist Colm McCarthy recently remarked, it is too late to do too little.