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Will Europhoria last?

Economic view

Europe has become the flavour of the month for investors all over the world. More precisely, it is the flavour of two months, since the bull market in European assets and the euro began on May 23. In my last column before going on holiday in mid-July I emphasised some genuinely positive developments in Europe: the seriousness of fiscal consolidation; the competitiveness of world-class European companies; and the co-operation between government and private enterprise that is helping to reposition businesses towards growth sectors such as alternative energy, advanced infrastructure and high value-added services.

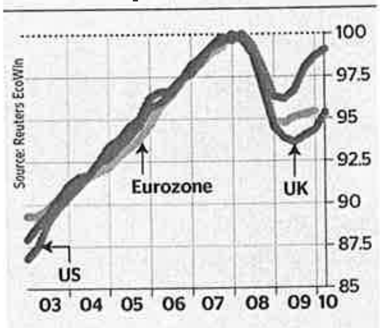
But does the present outbreak of Europhoria really mean Europe is emerging from its long period of economic underperformance? And are Europe's anti-Keynesian policies, now emulated by the Lib-Con coalition in Britain, really proving more successful than the US's textbook approach to macroeconomic management?

Starting with the good news for Europe — and the relatively bad news for the US — European governments have now announced programmes of long-term fiscal consolidation that could, at least in theory, fix the blowouts created by the financial crisis. More importantly these new fiscal policies, if fully implemented, will start to tackle the long-term demographic challenges facing European governments by reducing their pension obligations and health costs. In the US, by contrast, there is no political consensus on how to deal with the budget deficit. Democrats and Republicans are united only in their refusal to talk about the necessary cuts in medical costs, the one item of spending that genuinely threatens the solvency of the US.

Against this new-found fiscal responsibility there are three negative features of the European outlook, especially in relation to the US.

First, all the main European economies remain relatively weak. While strong-looking growth figures have recently been published in Germany, these merely reflect the fact that the eurozone, and Germany in particular, suffered a much deeper recession than the US after the Lehman crisis. Even if Germany grows by 1.5 per cent in the second quarter, as many economists predict, its GDP will still be 3.8 per cent below the peak level before Lehman. In the US, by contrast, GDP is now only 1 per cent below its previous peak. Thus the US economy will probably have fully recovered to its pre-recession output by the third or fourth quarter of this year while the German and European economies, if they grow at about 2 per cent as currently expected, will spend

GDP compared



another two years in the hole they stumbled into after Lehman.

Moreover, the US was growing much more rapidly than Europe before the crisis. Industrial production in the US today is 49 per cent higher than in 1990, whereas German industry has grown by only 23 per cent; in France and Britain production is only 3 per cent higher than it was 20 years ago, an annualised growth rate of just 0.1 per cent. Viewed from this standpoint it is hardly surprising that European surveys of business sentiment seem fairly optimistic. If European industrialists define normality as 0.1 per cent growth, a further decade of such stagnation may seem like a decent prospect.

The second problem for Europe is that the euro is still very expensive. Europe has smaller trade deficits than the US or Britain, but that is mainly a result of weak consumption and investment, rather than competitive production costs. According to the inflation-adjusted exchange rate indices compiled by the Bank for International Settlements, the euro is about 15 per cent more expensive than the dollar and 25 per cent more expensive than the pound. At today's exchange rates hourly labour costs, including social security taxes, pensions and healthcare payments, are 25 per cent higher in the eurozone than in the US and 34 per cent above British costs.

Third, Europe's post-Lehman recovery, far from refuting Keynesian economics, has been based on a standard Keynesian stimulus, which European (and British) politicians are now determined to reverse.

Meanwhile the theory that consumers and businesses would increase their spending in response to lower budget deficits is at odds with experience. Sado-monetarist policymakers have often predicted, as they do in Europe today, that rising confidence would offset the depressing effects of fiscal tightening, but they have usually turned out to be wrong — disastrously so in Japan in 1997 and Germany in 2004. In fact fiscal tightening has almost invariably been deflationary, as Keynesian economics predicted, unless offset by highly stimulative monetary policies. Falling interest rates were what turned fiscal deflation into economic expansion in the US, Canada and Sweden in the 1990s and in Britain after Black Wednesday, and, before that, after Geoffrey Howe's 1983 Budget.

The fiscal stimulus in most of Europe is now at its peak, but it will be reversed in 2011. Only then will we know if the fiscal tightening now promised will be beneficial or whether it will drag the eurozone and Britain into a pre-Keynesian 1930s-style depression — or whether governments will simply abandon their over-ambitious austerity plans.