

Economic Interests

Europe: Go Ahead and Spend, Please

By Bruce Stokes

BRUSSELS—When the leaders of the world’s 20 leading economies met in Washington in November, they promised to “use fiscal measures to stimulate domestic demand to rapid effect.” The \$825 billion stimulus package now under consideration on Capitol Hill is the U.S. contribution to that effort.

But in Europe, governments are moving much more slowly and ineffectively to counter the recession, with the prospect that they may spend much less than Washington does on fiscal stimulus. Since the European Union’s market is actually larger than the American economy, Europe’s failure to do its fair share threatens to prolong the global downturn and raises the specter of new trans-Atlantic finger-pointing.

“This crisis can lead us to fragmentation or integration,” said Jean Pisani-Ferry, director of Bruegel, a Brussels-based economics think tank. “Right now, the response is leading us toward fragmentation.”

The Obama administration is keen to get off on the right foot with the Europeans, whose help it needs on the challenges in Afghanistan, Gaza, and Iran. But the White House should not shy away from tough love in dealing with the Europeans about the economy. Last year’s financial calamity was largely of America’s making. But this year’s economic crisis engulfs everyone. And each nation must do its part if the world is to climb out of the hole.

Until late last year, European governments argued that their economies were sufficiently “decoupled” from the American economy to avoid

being dragged down by Wall Street’s woes. “We thought we could sail through a U.S. recession, and we did not,” Pisani-Ferry said.

Great Britain is now in its first recession in 18 years, after its economy fell 1.5 percent in the last quarter of 2008. The German economy, Europe’s largest, is expected to contract by 2.5 percent this year.

Many analysts believe that British banks are technically insolvent, meaning that they have insufficient assets to cover their debts. The German weekly newsmagazine *Der Spiegel* reports that German banks are sitting on \$390 billion in toxic assets, significantly more than previously thought. Analysts believe that other European banks may face similar problems.

Weaker European economies are having trouble financing their debt. “The markets are sniffing out the weakest links,” said Joseph Quinlan, a senior fellow at the Center for Transatlantic Relations at Johns Hopkins University’s School of Advanced International Studies. In mid-January,

the Greek government had to pay 2.53 percentage points more in interest to borrow money than the German government did, the largest such spread since the inception of the euro a decade ago. The Irish government was paying 1.73 percentage points more than Germany.

Speculation is rampant here that the International Monetary Fund may need to bail out Greece, Ireland, and Portugal, just as it earlier rescued Hungary and Latvia. “This whole thing is slowly sinking down the drain,” Quinlan said. “People have been asleep at the switch.”

In recent days, European governments have announced plans for new spending and loan subsidies, but their efforts fall short of what may be needed. E.U. tax cuts and government expenditures will equal only 0.8 percent of the Union’s gross domestic product in 2009, according

■ Pump-Priming in Europe

In 2009, economic stimulus efforts by European Union countries in the form of tax cuts and new government expenditures will total about 110.2 billion euros, or \$143 billion, approximately 0.8 percent of the Union’s gross domestic product. Below are the planned stimulus packages for the 13 E.U. member states that account for 90 percent of the E.U. market.

Tax cuts and fiscal expenditures for the 13 largest European Union countries

	BILLIONS, IN EUROS	% GDP
Germany	35.8	1.4
United Kingdom	16.7	1.0
France	14.3	0.7
Spain	12.3	1.1
Austria	3.9	1.3
Netherlands	2.2	0.4
Poland	1.6	0.5
Belgium	1.2	0.3
Sweden	0.1	0
Denmark	0.0	0
Ireland	0.0	0
Greece	0.0	0
Italy	-0.3	0

SOURCE: Bruegel

to calculations by David Saha and Jakob von Weizsacker, economists at Bruegel. This is substantially less than the European Commission's spending target of 1.2 percent. By comparison, U.S. fiscal stimulus will equal about 2.9 percent of the economy this year.

After much foot-dragging and criticism from other governments, Germany added to its spending plan, which is now expected to total about 1.4 percent of GDP, including outlays for infrastructure investment, a tax cut for low-income people, incentives for consumers to buy energy-efficient cars, lower health insurance contributions, and increased support for families with children. But the IMF thinks that Berlin should be spending at least 2 percent of GDP. Only four of the 27 E.U. member states are expected to lay out more than 1 percent of GDP.

European governments also plan to subsidize loans for the private sector. In response to the bursting of Spain's domestic property bubble, Madrid will make available credit subsidies equal to 4.9 percent of its GDP. And Germany's new stimulus package includes a \$130 billion loan guarantee fund for industry. Altogether, these credit measures come to 2.5 percent of GDP for the E.U. as a whole, although it is highly unlikely that all of this credit will be used in 2009. And credit subsidies do not prime the economic pump as effectively as does government spending.

E.U. apologists are quick to lump together everything that member states are doing on the spending and credit fronts to make the case that Europe is doing its part to restart the world economy. Bruegel's von Weizsacker disagrees. "Declaring victory on the European stimulus package by simply adding extra credit provisions to the direct fiscal stimulus would be questionable on economic grounds. The likely real impact on aggregate demand may well be more limited than suggested by [this] headline figure."

One reason is that the planned stimulus efforts are likely to have varying effects from country to country. Daniel Gros, director of the Center for European Policy Studies in Brussels, argues that in Spain and the United Kingdom, where households are net borrowers, tax cuts and government spending should prevent a sharp drop in consumption. But in Germany, where households do not depend on credit, an increase in disposable income will probably just lead to more savings.

Moreover, as Stefan Collignon, a professor of European economic policy at St. Anna School of Advanced Studies

in Pisa, Italy, notes, the planned German tax cuts would provide a family with a \$32,000 yearly income only an additional \$176 to spend.

America has a huge stake in Europe's getting its fiscal stimulus right. The European Union buys a fifth of U.S. exports, and the sales of U.S. affiliate companies in Europe are eight times greater than American exports to the E.U. The health of the U.S. economy and of U.S. businesses is inextricably tied to E.U. economic recovery. But if the United States bounces back from the recession stronger and faster than Europe does, sucking in even more European goods and services, the nearly \$100 billion U.S. trade deficit with the European Union will worsen.

"We need a recovery with the E.U. and the U.S. coming out together," Quinlan said. "Then we will be on a path toward a more balanced world."

To that end, the Obama administration needs to press its European counterparts to do more, in a more concerted

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fashion, to boost their economies. Economists generally agree that that means additional spending. Now is not the time to worry about government debt. To lower the cost of raising these funds and to spread the burden of their repayment, Gros and Stefano Micossi, director of ASSONIME, a think tank in Rome, have suggested the

creation of a European Financial Stability Fund that would issue bonds on the international market, with the backing of European governments, to recapitalize European banks.

Wolfgang Munchau, director of *Eurointelligence*, a website for economic commentary, has proposed a joint European market for government treasury bills that would be larger and more liquid than the existing market for European government bonds. Such a market could lower borrowing costs.

Barry Eichengreen, a professor of economics and political science at the University of California (Berkeley), contends that the European Central Bank has to end its phobia about inflation, cut interest rates to zero, and inject liquidity into the financial system by lending money to deposit-taking institutions or by buying assets from banks, as the U.S. Federal Reserve is now doing.

"We need to ensure that what each government is doing is mutually reinforcing," said John Richardson, director of the Brussels Forum, an annual high-level meeting of American and European political, corporate, and intellectual leaders. That is the message that President Obama must send to Europe—and soon. ■

bstokes@nationaljournal.com