Preparing For Europe's Next Recession

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If you do not understand what is happening to the eurozone economy, you are not alone. One day we are told that growth is definitely passé; the next that recovery is on track; and the third that the European Central Bank is considering sending checks to all citizens to boost output and revive inflation. Rarely has the economic picture been so confusing.

Start with medium-term growth. Since the global financial crisis erupted in 2008, productivity has grown at a snail's pace. Oddly, the smartphones' magic computing power does not seem to offset the slowdown in efficiency gains in manufacturing and standard services. For almost a decade, annual productivity growth in the advanced economies has been close to 1%, versus 2% previously.

This may be a temporary lull or a statistical illusion. But with no evidence that it will end, policymakers have downgraded their forecasts. Since 2010, the US Congressional Budget Office has lowered its outlook for productivity growth in the decade to 2020 from 25% to 16%; so has the United Kingdom's Office for Budget Responsibility, reducing its forecast from 22% to 14% productivity growth. Everyone is adjusting to leaner times.

The surest way to buck this trend is to invest in education, promote innovation, and foster efficiency. In Europe, especially, a broad array of reforms could contribute to bridging a growing efficiency gap with the US. The ECB can exhort or incentivize, but it is governments that must act.

Turn now to current growth. In 2015, eurozone output barely exceeded its 2008 level, a dismal performance for which sluggish productivity growth cannot be blamed. Despite considerable slack in the economy, growth in 2015 was a disappointing 1.5%, and the ECB expects just 1.4% growth this year. This is far better than the contraction that occurred from 2011 to 2013, but one would expect a growth surge in an economy benefiting from a favorable exchange rate, record-low interest rates and the plunge in oil prices.

Austerity is not the culprit. Whereas premature consolidation of public budgets was largely responsible for causing a double-dip recession five years ago, fiscal policy has been broadly neutral since 2015.

Part of the explanation is the slowdown of the emerging economies. But such external factors also apply to the UK and Sweden, yet their growth rates are 2-3%. The truth is that the eurozone lacks internal momentum. Despite income growth, households are reluctant to consume and build; and, despite a surge in profits, companies are not inclined to take risks and invest.

One reason for wariness is that the future looks bleak. This is why reforms that strengthen the economy in the medium term can help in the short term, too. Another reason is that the past weighs too heavily on the present: because inflation is so low, accumulated debt does not go away and agents are forced to save to pay it down. Finally, unemployment in parts of the eurozone remains too high for households to regain confidence, while the fiscal stance is not distributed across countries in a way that maximizes growth prospects. This enduring malaise sustains below-target inflation, which in turn keeps real interest rates too high.

With the economy more fragile than it should be, the ECB has crossed one Rubicon after another in order to spark inflation. Despite renewed efforts, however, the battle remains undecided.

A third question must therefore be asked: What could the eurozone do if confronted with a severe deterioration in the global environment – for example, a precipitous interest-rate hike in the United States or an outright recession in China?

In such a case, private demand would contract; and, with heavily indebted governments keen to avoid being caught off guard by a surge in risk aversion, public demand would not come to the rescue. The memory of the 2011 sovereign-debt crisis remains fresh, and many officials would refrain from using fiscal policy to prop up the economy. At the same time, the ECB would have reached the limit of quantitative easing.

But to let a new recession happen after a short and feeble recovery would be regarded by citizens as a major policy failure, which would further weaken support for the euro.

Against this background, the ECB is openly pondering the right response. In a recent interview, Peter Praet, its chief economist, explicitly noted that "all central banks" can print money and send checks to each and every citizen – a last-resort option known as "helicopter money." Because households would spend part of the windfall, a helicopter drop would boost both domestic demand and the price level.

Helicopter money raises both legal and technical difficulties. More fundamentally, orthodox economists claim that it would be a quasi-fiscal operation for which the central bank has no explicit mandate. Its advocates reply that the ECB does have a mandate to keep inflation close to 2%, and that it should consider all options – even highly unconventional ones – to achieve that target.

It is true that a helicopter drop would be functionally equivalent to a direct government transfer to households, financed by central banks' permanent issuance of money. So helicopter money, while consistent with the ECB's price stability mandate, would indeed blur the distinction between monetary and fiscal policies.

Could an explicitly fiscal option be embraced instead? Assuming individual governments would not want to spend, the eurozone as an entity could borrow to finance growth-enhancing policies. A sort of beefed-up Juncker plan (the European Commission president's scheme to invest €315 billion over three years), based on preselected projects to be activated when the time is right, would provide a significant hedge against the risk of recession.

Such projects could be investments that would help limit global warming, or investments to equip the labor force for the digital economy. Borrowing would be carried out jointly and should be backed by a dedicated source, either a tax or a defined GDP-based contribution that would enable the eurozone to pay down its debt.

The political difficulties inherent in such a scheme would no doubt make agreement difficult. It is not clear whether eurozone-wide borrowing would be easier to contemplate than an ECB-engineered quasi-fiscal transfer. What is clear is that the eurozone should evaluate these options, because either one might well be needed sooner or later.