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The REAL state of the European economy

...and how to fix it

The eurozone economy is doing better than expected this year. Growth is stronger everywhere and positive even in Greece. Unemployment is falling. In his State of the Union speech on 13 September, Jean-Claude Juncker, the president of the European Commission, will doubtless celebrate this long-awaited recovery as a success for eurozone policymakers' crisis management.

But even with this welcome upturn, the economic situation is far from rosy. Ten years after the start of the financial crisis, bad debts continue to bedevil weak eurozone banks, weigh down on overstretched households and companies and depress demand. Two-and-a-half years after the European Central Bank (ECB) finally followed the lead of other major central banks and launched a bond-buying programme known as quantitative easing (QE), underlying inflation remains well below its near two per cent target. And the eurozone's potential for long-term growth is hampered by dismal demography – an ageing and shrinking working-age population combined with swelling ranks of pensioners – and poor productivity growth.

Indeed, the eurozone's performance over the decade since the crisis struck has been catastrophic – largely due to bad policy decisions and flawed governance. Average living standards – as measured by gross domestic product (GDP) per capita – are no higher than a decade ago. The eurozone has performed much worse than the United States since the crisis – and worse even that Europe fared during the Great Depression of the 1930s.

Most Europeans have suffered a lost decade of stagnant or falling wages. Unemployment remains scarily high in southern Europe, especially among young people. A common currency that was meant to bring Europeans together has instead led to economic divergence and political division. Germany has got richer and Greece much poorer.

Fortunately, some of the worst policy decisions have been corrected or mitigated. The existential panic that eurozone policymakers provoked in 2011 and 2012 – and their lurch into extreme austerity that caused an unnecessary recession – are in the past. Yet eurozone policies and governance remain dysfunctional and undemocratic.

The enduring legacy of the crisis is that the political economy of the eurozone has been transformed; what began as a voluntary union of equals has become a glorified debtors' prison. Misguided bank and sovereign bailouts have turned clashes between private creditors and debtors across the eurozone into national conflicts between creditor governments and debtor ones, with EU institutions becoming instruments for creditors to impose their will on debtors. Germany has been thrust into the driving seat, and it generally acts in its narrow interests as a creditor instead of those of the system as a whole.

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There have been welcome steps to create a eurozone system for resolving failed banks that imposes losses on their creditors rather than on taxpayers. But it remains flawed. The Italian government got the green light to inject public money into failed banks this year. And it remains doubtful whether the many weak banks in Germany would ever be wound down without taxpayer funds.

A dangerously tight fiscal straightjacket has been imposed: both a much tougher Stability and Growth Pact and the Fiscal Compact. This rigidly prevents national governments from stimulating the economy enough in a slump. It narrowly treats each eurozone member as if it were an island, neglecting the overall fiscal stance of the eurozone and its interaction with monetary policy. And it perversely limits productive public investment that would boost demand now as well as future growth – and hence actually strengthen public finances. At a time when interest rates are at record lows and resources are lying idle, it is a tragic missed opportunity not to be investing enough in the future.

Wages have also been driven down in the perverse pursuit of export competitiveness: beggaring our neighbours and ourselves. Economic adjustment has been not just asymmetric, but one-sided: countries running current-account deficits have been forced into surplus, while those running surpluses – notably Germany – run ever larger ones.

While Germany insists that the fiscal rules must always be followed, it refuses to comply with EU rules on dangerous macroeconomic

imbalances. The European Commission is complicit: even though Germany's vast current-account surplus of 8 per cent of GDP is the biggest and most dangerous imbalance in the eurozone, it fails even to try to enforce the rules against Germany.

Financial flows have fragmented and capital controls been imposed within the eurozone in Cyprus and Greece. Greece has been threatened with a brutal Grexit.

While ECB President Mario Draghi's promise to do 'whatever it takes' has held the euro together, he has also taken away the political pressure that might have actually resolved the crisis. Instead an acute crisis has become a chronic one. The euro is held together more by fear of the exit costs than by the belief that it makes Europeans better off.

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As a result of all this, the political capital of the European project built up over decades has been greatly eroded in just a few years. Animosity among Europeans has soared, with old stereotypes revived and new grievances created. And there is a burning sense of injustice that policymakers are incompetent, unaccountable, self-serving and even corrupt. All of which feeds into nationalist and xenophobic resentment that is destroying Europe.

This German-dominated, creditor-run, fiscally austere and deflationary eurozone is undesirable, undemocratic and ultimately unsustainable. Greece cannot forever be run as a debt colony of its eurozone creditors.

The ECB needs a political master. Whereas other independent central banks have narrowly defined remits and are ultimately answerable to an elected government and parliament, the ECB enjoys extreme independence, enshrined in an EU treaty that is very difficult to amend. It floats above elected national governments, bossing them around at will.

The ECB decides whether to buy government bonds in a panic, and on what conditions. It chooses whether or not to extend emergency liquidity to a country's banks. As part of the Troika with the European Commission and the IMF, it continues to set economic policies for Greece, and has obstructed the necessary restructuring of its debts. And it is scarcely accountable to the European Parliament, which lacks the requisite information or powers to discipline central bankers for overstepping their mandate. At the very least, the ECB should not abuse its vast, unaccountable power by acting in a brazenly political way on

issues well outside its monetary-policy remit.

Nor is it acceptable to strip voters of the right to make legitimate economic and political choices, not least about tax and spending. Government after government has been elected with a popular mandate to end harmful austerity, yet each is ultimately forced to back down by Germany and the EU institutions. Thus as well as being economically damaging, the eurozone's fiscal straitjacket is politically disempowering. Is it any wonder that angry voters increasingly turn to the anti-EU extremes? No taxation without representation was the rallying cry of the American Revolution; no austerity without accountability may now be its European equivalent.

We desperately need a European Spring of economic and political renewal.



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