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Europe's economic crisis: some ideas for recovery and growth

Supporters of excessive austerity have made overcoming the eurozone crisis more difficult and costly

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Workers set up an election poster of the Green party, Die Gruenen, for Germany's upcoming general elections. The writing reads: "Its always the others who are to blame." Photograph: Thomas Peter/REUTERS

The eurozone had been contracting for eighteen months since the second half of 2011. Though recent news is better, the European Central Bank projects Eurozone GDP will decline by 0.6% in 2013. The UK economy is not doing much better in terms of economic growth. Future growth is further threatened by the sharp fall in investment, especially pronounced in the UK and Southern Europe.

Eurozone unemployment is horrendously high at over 19 million people, and a rate of 12%. In Spain and Greece unemployment is over 26% and youth unemployment over 50%. In the whole of the EU, 26 million people are unemployed.

"Austerians" have argued that the policies followed were necessary to reduce the debt overhang. However, the ratio of debt to GDP has risen in all EU regions since 2008, and especially in the UK and the eurozone periphery where austerity has been practised most rigorously. Due to bad economic analysis and worse arithmetic, supporters of excessive austerity have made overcoming both the crisis of debt and of growth more difficult and costly.

Are there alternatives to achieve quick recovery of growth and employment? Clearly yes! In Germany, the government should encourage higher wages which would boost consumption , and encourage higher imports from the rest of Europe. Wages recently started to increase In Germany, but too slowly. It is surprising that Germany, an advanced economy, has no minimum wage policy. Encouragingly both the Social Democrats (SPD) and the Greens are proposing a minimum wage policy.

Fiscal consolidation in Germany is being adopted far too quickly at the federal and state levels. Particularly harmful is the policy that in the states (Länder) no new public debt is allowed from 2020. Ideally this policy should be modified. If this is not possible, then consolidation should be achieved by increasing taxes to maintain – or increase - investment in sectors like green infrastructure. Recent modelling shows such investment would encourage growth and employment in Germany and the rest of Europe.

The case for slower fiscal consolidation in the UK is also extremely clear. Bagaria, Holland and Van Reenen at the National Institute have shown that if fiscal consolidation in the UK was postponed till growth was restored, aggregate GDP would be at a significantly higher level by 2021 than with the current excessive austerity policies. The reason is that too early fiscal austerity is particularly inappropriate, as the IMF has emphasised, when fiscal multipliers are very high during or after crises and private bank lending is insufficient due to risk aversion. Again, higher UK growth would boost, via trade, growth in the rest of Europe, replacing vicious circles with virtuous ones.

The pace of fiscal consolidation needs to also be reduced in the European periphery countries. The troika should allow slower fiscal consolidation, and support measures to encourage growth and employment, via financing economically viable projects. Most urgent is the case of Greece, where GDP has fallen by a quarter.

Though national measures are clearly important, more needs to be done at European level. The doubling of the paid-in capital of the European Investment Bank, Europe's public development bank, was a visionary act by EU leaders. But till now it has not been sufficiently used. Indeed it was counter-productive that EIB lending actually fell in 2012, when private bank lending was falling in much of the EU. It is important that EIB lending increases rapidly. EIB lending to small and medium enterprises is growing quite substantially; this has to be further expanded as SMEs are an important source of employment. It needs to be complemented by the EIB increasing financing of investment in decentralised projects, such as those that foster innovation and increase energy efficiency.

It is particularly effective if EIB loans are co-financed by national development banks, as this will increase the multiplier effect of EIB loans, and leverage national public resources. Germany has a large, effective and profitable development bank – KfW. France just created a public development bank; the Labour party is proposing a British investment bank to fund both infrastructure and SMEs. Crisis-hit countries like Greece and Ireland also urgently need to create national development banks. The EU budget needs to be restructured to increase the proportion going to investment and growth. Particular emphasis should be placed on measures to increase youth employment immediately.

There are clear policies to create growth, jobs and hope in Europe. All we need is for politicians and policymakers to have the vision and courage to pursue them.

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