

How to Save the European Economy From Death

By [Joseph Stiglitz](#)

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The outcome of the Italian elections should send a clear message to Europe's leaders: The austerity policies that they have pursued are being rejected by voters.

The European project, as idealistic as it was, was always a top-down endeavor. But it is another matter altogether to encourage technocrats to run countries, seemingly circumventing democratic processes, and foist upon them policies that lead to widespread public misery.

While Europe's leaders shy away from the word, the reality is that much of the European Union is in depression. The loss of output in Italy since the beginning of the crisis is as great as it was in the 1930s. Greece's youth unemployment rate now exceeds 60 percent, and Spain's is above 50 percent. With the destruction of human capital, Europe's social fabric is tearing, and its future is being thrown into jeopardy.

The economy's doctors say the patient must stay the course. Political leaders who suggest

otherwise are labeled populists. The reality, though, is that the cure is not working, and there is no hope that it will — that is, without being worse than the disease. Indeed, it will take a decade or more for Europe to recover the losses incurred in this austerity process.

In short, it is neither populism nor shortsightedness that has led citizens to reject the policies that have been imposed on them. It is an understanding that these policies are deeply misguided.

Europe's talents and resources — its physical, human and natural capital — are the same today as they were before the crisis began. The problem is that the prescriptions being imposed are leading to massive underutilization of these resources. Whatever Europe's problem, a response that entails waste on this scale cannot be the solution.

The simplistic diagnosis of Europe's woes, that the crisis countries were living beyond their means, is clearly at least partly wrong. Spain and Ireland had fiscal surpluses and low ratios of debt to GDP before the crisis. If Greece had been the only problem, Europe could have handled it easily.

An alternative set of well-discussed policies could work. Europe needs greater fiscal federalism, not just centralized oversight of national budgets. To be sure, Europe may not need the 2-to-1 ratio of federal to state spending found in the United States, but it clearly needs far more European-level expenditure, unlike the current minuscule EU budget, which has been whittled down further by austerity advocates.

A banking union is needed, too. But it needs to be a real union, with common deposit insurance and common resolution procedures as well as common supervision. There will also have to be eurobonds or an equivalent instrument.

European leaders recognize that without growth, debt burdens will continue to grow and that austerity by itself is an anti-growth strategy. Yet years have gone by, and no growth strategy is on the table, though its components are well-known: policies that address Europe's internal imbalances and Germany's huge external surplus, which now is on par with China's — and more than twice as high relative to GDP. Concretely, that means wage increases in Germany and industrial policies that promote exports and productivity in Europe's peripheral economies.

What will not work, at least for most eurozone countries, is internal devaluation — that is, forcing down wages and prices. This would increase the debt burden for households, firms and governments, which overwhelmingly hold euro-denominated debts. And with adjustments in different sectors occurring at different speeds, deflation would fuel massive distortions in the economy.

If internal devaluation were the solution, the gold standard would not have been a problem in the Great Depression. Internal devaluation, combined with austerity and the single-market principle, which facilitates capital flight and the hemorrhaging of banking systems, is a toxic combination.

The European project was and is a great political idea. It has the potential to promote both prosperity and peace. But rather than enhancing solidarity in Europe, it is sowing seeds

of discord within and between countries.

Europe's leaders repeatedly vow to do everything necessary to save the euro. European Central Bank President Mario Draghi's promise to do "whatever it takes" has succeeded in providing a temporary calm. But Germany has consistently rejected every policy that would provide a long-term solution. The Germans, it seems, will do everything except what is needed.

Of course, the Germans have reluctantly come to accept the necessity of a banking union that includes common deposit insurance. But the pace with which they accede to such reforms is out of kilter with the markets. Banking systems in several countries are already on life support. How many more will be in intensive care before a banking union becomes a reality?

Yes, Europe needs structural reform, as austerity advocates insist. But it is structural reform of the eurozone's institutional arrangements, not reforms in individual countries, that will have the greatest impact. Unless Europe is willing to make those reforms, it may have to let the euro die to save itself.

The EU's Economic and Monetary Union was a means to an end, not an end in itself. The European electorate seems to have recognized that under current arrangements, the euro is undermining the very purposes for which it was supposedly created. That is the simple truth that Europe's leaders have yet to grasp.

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