



## A Gloomy Outlook in Europe: Part I

*Adam S. Posen says a “panic” by European economic policymakers led to too much fiscal consolidation, unnecessarily stifling prospects for economic growth.*

*Transcript of interview recorded November 9, 2012. © Peterson Institute for International Economics.*

Steve Weisman: Adam Posen, incoming President of the Peterson Institute for International Economics is here with me, Steve Weisman, to discuss the world economic outlook and focus on Europe and its effects on the United States. We'll do this in two parts. First, what are the prospects for economic growth in the next year or two in Europe?

Adam Posen: I think they're pretty abysmal. I think it's going to be kept within a pretty tight channel, whether it's going to be mildly negative on this or barely positive on that, meaning that Germany and France and a couple of the small countries might get a little bit of positive growth and the smaller, but still important countries like Spain, Italy, Portugal, Ireland, are going to have pretty strong negative growth. And I see that persisting for the next couple of years.

Steve Weisman: This negative growth in the southern tier or periphery is this a result of policies? Or is it just the inevitable aftermath, of the financial crisis?

Adam Posen: I should be clear. Negative growth means contraction, and contraction rather than stagnation is largely the result of policy. Nobody was going to have a great time coming out of the kind of financial boom and bust that we did, especially when your path has suffered through what the U.S., U.K, and the rest of the world did. But there's also little question in my mind that the relatively unaggressive stimulus program from the European Central Bank, although much better than it was, and the common front of austerity that is being posed on a whole range of these countries simultaneously, are together putting a floor under the worst events, but a very tight ceiling on how high they can go.

Steve Weisman: Was it a failure to step up to the plate by the Central Bank, but also too much fiscal consolidation too fast?

Adam Posen: More fiscal consolidation isn't always better. Partly there is the timing issue, which is the same one the U.S. faces. You know, you do need to make your debts balance in the long run, but you don't necessarily win by cutting back on your government expenditure when you're in a downturn, because then the growth gets even worse and it can end up actually making your debt even worse.

But the second thing that's going on is, unlike the U.S., Canada, Japan, the countries in the euro area don't have their own currencies, don't have their own monetary policy, so there's also less of an offset to the fiscal policy than we have.

Steve Weisman: You mentioned in your talk that something similar to what happened in the United States, where Governor Romney went around saying, “If we don't have fiscal consolidation or in this case, just spending cuts, we're going to be Greece. But you seem to suggest that nobody in Europe wanted to be Greece either, and they were rushing too quickly toward this austerity and consolidation.

Adam Posen: I think there was a bit of a panic. I mean, Steve, clearly when we talk about Greece, unfortunately we're talking about a country which has very little ability to collect taxes, huge debts, very little ability to pay them off and so it's understandable other countries don't want to become like that.

But most of the other countries in Europe -- or the U.S. for that matter -- are not in danger of becoming that. You look at Spain or Ireland, for example. Their public debt levels versus the size of their economies were actually quite low prior to the crisis itself. While they went up some because of the fiscal boom and bust, they've gone up more because of the mixed policies and the recession and the tight strait jacket they're in within the euro area.

Another way to think about it is, besides the timing issue, there is a question of degree. Not just how fast you have to consolidate, but what size of consolidation you need to make. And in the spirit of what you were saying, I think the countries had gotten themselves into a panic. There was a G7 meeting in May of 2010 or April of 2010, I remember, and all the officials from all the major economies were busy sort of outbidding each other: "Oh, I can do more austerity than that, or I can name that austerity in three notes, I can name that austerity in two notes." I mean, it was just a bidding war, to mix metaphors, it was the least ugly contest and no one wanted to be the ugliest.

Steve Weisman: But there were other players, like the IMF [International Monetary Fund], the ECB [European Central Bank], the European Union leadership -- they were all going in this direction, weren't they?

Adam Posen: Absolutely. The IMF to its credit was going less in this direction at the time than most of the other players and more recently has really very clearly been, I think, quite reasonable and factual about being less gung ho.

I think the only player, this sort of Hamlet, the prince, is the markets. And so just as we had a discussion in the U.S. where people say, "Oh well we had to do this, we couldn't do more stimulus, we had to raise taxes, we had to keep the budget from going out of control, because otherwise the markets would dump the dollar. Otherwise the markets would drive up interest rates."

That was really what was driving us -- this echo chamber of politicians and economists who said, "The markets are going to kill us," when in fact what the markets have done frankly is beat them when they've had bad growth, not when they've had more debt.

Steve Weisman: Of course everybody seems to interpret the markets like a Rorschach test and the markets were gyrating for a period and even well into this year, weren't they?

Adam Posen: Absolutely. But part of what we do here at the Peterson Institute ideally is not make it just a matter of servile impressionistic opinion, but try to sort through the data. And so an exercise that I and some colleagues did is pretty straight forward, but it's very instructive.

You can see, for example, that interest rates on government bonds in Europe, which shot way up during the gyrations you're talking about, came down sharply, 100 basis points or more, a full percentage point, the moment the ECB announced they might intervene. That indicates that this was all about a panic, and that once the Central Bank was ready to step

in, the panic would stop. If it was fundamental, the Central Bank stepping in wouldn't have been enough to save it.

Similarly, if you look across countries over time, what you find is the countries that have the highest debt levels didn't necessarily have the highest interest rate premium. It's not like credit card borrowers, like the 18 year old drug addict has to pay 500 basis points and the 60 year old civil servant pays no premium. I mean, everybody was basically paying the same premium, which is another way of saying it was a panic.

Steve Weisman: Adam, I'm going to stop there and in Part II of this interview, we're going to talk about the U.S., the effect of Europe on the U.S., but also some interesting things about what the U.S. might do when it speaks to Europe.



