Europe's *Challenge*

BY KENNETH ROGOFF

Will the reform process resume once the recovery begins?

What will Europe's growth trajectory look like after the financial crisis? For some Europeans, still nervous that their economies and banking systems might collapse, this is a little like asking a passenger on the *Titanic* what they plan to do when they arrive in New York. But it is a crucial question to ask, especially when Europe has been facing so much outside pressure from the likes of the United States and the International Monetary Fund to focus on short-term Keynesian stimulus policies.

True, things are pretty ugly right now. Europe's income is projected to fall a staggering 4 percent this year. Unemployment will soon be in double digits throughout most of the Continent, with Spanish and Latvian unemployment on track to exceed 20 percent. Europe's banking system remains sickly, even though many national governments have gone to great lengths to hide their banks' woes.

Yet, ugly or not, the downturn will eventually end. Yes, there is still a real risk of hitting an iceberg, beginning perhaps with a default in the Baltics, with panic first spreading to Austria and some Nordic countries. But, for now, a complete meltdown seems distinctly less likely than gradual stabilization followed by a tepid recovery, with soaring debt levels and lingering high unemployment.

It is not a pretty picture. Some commentators have savaged Europe's policymakers for not orchestrating as aggressive a fiscal and monetary

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policy as their U.S. counterparts have. Why else is Europe suffering a deeper recession than America, they complain, when everyone agrees that the United States was the epicenter of the global financial meltdown?

But these critics seem to presume that Europe will come out of the crisis in far worse shape than the United States, and it is too early to make that judgment. An epic, financial crisis-driven recession, such as the one we are still experiencing, is not a one-year event. So policymakers' responses cannot be evaluated by short-term measures, either. It is just as important to ask what happens over the next five years as over the next six months, and the jury is still very much out on that.

America's hyper-aggressive fiscal response means a faster rise in government debt, while its hyper-expansive monetary policy means that an exit strategy to mop up all the excess liquidity will be difficult to execute. Government spending in the United States has risen in short order from 18 percent to 28 percent of income, while the U.S. Federal Reserve has effectively tripled its balance sheet. Europe's more tempered approach, while magnifying short-term risks, could pay off in the long run, especially if global interest rates rise, making it far more painful to carry oversized debt loads.

The real question is not whether Europe is using sufficiently aggressive Keynesian stimulus, but whether Europe will resume its economic reform efforts as the crisis abates. If Europe continues to make its labor markets more flexible, its financial market regulation more genuinely pan-European, and remains open to trade, trend growth can pick up again in the wake of the crisis. If European countries look inward, however, with Germany pushing its consumers to buy German cars, the French government forcing car companies to keep unproductive factories open, and so forth, one can expect a decade of stagnation.

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Admittedly, the past year has not been a proud one for policy reform in Europe. Recessions have never proven an easy time for European leaders to push forward with reforms. Matters were not helped when the Czech government lost a confidence vote midway through its six-month presidency of the European Union, leaving a lame duck European Commission. The shadow of forthcoming elections in Germany, together with concern over whether Irish voters will ratify the Lisbon treaty (giving Europe a badly needed new constitution), has conspired to impede reform momentum.

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Yet Europe's many strengths, including strong democratic governments and sound legal institutions, are often underrated as long-term competitive strengths in today's globalized economy. The recent recession has presented challenges, but European leaders were right to avoid becoming intoxicated with short-term Keynesian policies, especially where these are inimical to addressing Europe's long-term challenges.

If reform resumes, there is no reason why Europe should not enjoy a decade of per capita income growth at least as high as that of the United States. Moreover, with growing concerns about the sustainability of U.S. fiscal policy, the euro has a huge opportunity to play a significantly larger role as a reserve currency.

One shudders to think what will happen if Europe does not pull out of its current funk. Certainly, Europe would lose traction as a badly needed counterweight to the United States in world economic policy. Europeans may not mind this right now (one sees more Obama T-shirts in Europe than in the United States), but they might not be so happy if a George Bush III comes along. Fortunately, Europeans will probably not wait so long to start moving ahead again. ◆