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A growth agenda for the eurozone

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It had been a deceptively mild end to the winter for the eurozone's economy. Bountiful showers of money from the European Central Bank helped to lower yields on Spanish and Italian bonds. Equity markets were temporarily soothed and some commentators had even started speculating about the first shoots of recovery appearing with the spring.

Reality, however, has been much harsher. In February, the jobless count across the 17-country bloc rose for the tenth consecutive month, reaching 10.8 per cent. Unemployment in Spain is close to 24 per cent – with youth unemployment going above 50 per cent. Forward-looking purchasing managers indices have remained weak in some parts of Europe.

These figures should not surprise. The mantra of austerity and its resulting ritual – the fiscal compact – were bound to create short-term misery, particularly in the eurozone's periphery. Fiscal hawks would argue this is the price to pay for the profligacy of the recent past.

Universal austerity is proving to be self-defeating, however. Lower growth rates are reducing tax receipts. It is unlikely that countries in the periphery will reach the deficit targets agreed with the EU, despite the severe belt-tightening. Austerity is also causing widespread resentment among the population. This forces the governments of Spain and Italy to be less ambitious in the structural reforms than they should be.

Old fears are re-emerging in the markets. Interest rates on Madrid's 10-year bonds are edging dangerously close to 6 per cent. Italy's yields are also rising fast – while European equities head in the opposite direction.

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To avoid sliding back into a repeat of last year's chaos, Europe desperately needs a growth agenda. This must involve demand management, not just supply-side reforms. And while peripheral countries should continue to put their fiscal houses in order, the core must be willing to take up more of the economic slack.

First, Europe must increase its level of investment. Austerity has led peripheral governments to cut back spending on public works. While this is inevitable, they should not overdo it. Just as importantly, countries of the core – currently enjoying near-zero real interest rates – should increase public investment. The Commission should do what it can to support infrastructure spending on a pan-European basis.

Second, the eurozone must do more to support the internal devaluation pursued by the countries at its periphery. Wages in these member states will eventually fall enough, but the process will be long and painful. A co-ordinated fiscal move could make the process smoother. Countries such as Spain and Italy should shift taxation from labour to consumption, but Germany and other surplus countries could help by doing the opposite. The effect would be to stimulate consumption in the core, while reducing unit labour costs in the periphery.

Third, there is room for further monetary easing. A new three-year longer-term refinancing operation should take place only in a real emergency. The ECB should cut its policy rate, however, which is currently at 1 per cent.

Political consensus behind such a growth agenda will not be easy to build. But as economic conditions get tougher, the high priests of fiscal austerity are bound to become more isolated. It is therefore encouraging that an increasing number of politicians, including François Hollande, the French presidential hopeful, are calling for a "European growth strategy".

Any such plan must include concrete measures that can have an immediate impact. Europe has been been talking too much about growth for too long, while doing too little. It is time to act before it is too late.

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