BERLIN—A standoff among the European Central Bank, Germany and other eurozone governments is holding back Europe’s quest to revive its flagging economic recovery.

The tensions, brewing for months, have sharpened this month as eurozone economic data have deteriorated and threaten to prevent a coherent policy response as Europe’s economy slides toward a third recession in six years.
A growing number of policy makers and advisers say a coordinated push is now needed, comprising aggressive new ECB actions, higher investment spending by Germany and European Union institutions, and bolder economic overhauls in France and Italy.

‘The worst thing we could do would be to repeat yesterday’s mistakes,’ Wolfgang Schäuble said. Lapresse/Zuma Press

“We need a grand bargain in which national governments understand that monetary policy can only be successful when accompanied by structural reform and responsible fiscal policy,” including less-austere policies in Germany, said Marcel Fratzscher, head of the German Institute for Economic Research, a nonpartisan Berlin think tank.

Even such a coordinated push might not be enough to return the eurozone to faster growth, given the currency zone’s deep problems, officials and economists warn. But in its absence, the risks of a near-term recession and longer-term decline are rising, many argue.

A 1.8% fall in eurozone factory output in August, published on Tuesday, was the latest indication that the 18-country currency bloc may have contracted in the third quarter, following its second-quarter decline.

Also on Tuesday, Germany slashed its official growth forecasts, while inflation readings for France and the U.K.—which doesn’t use the euro but is exposed to the bloc’s economic woes—were unexpectedly weak.
The ECB, under pressure to buy financial assets on a large scale to reanimate business activity and inflation, isn’t confident such a step would work in isolation and fears a political backlash in Germany.

ECB officials would prefer to launch further, potentially risky measures while governments make complementary moves to revive their economies, people familiar with central bank officials’ thinking say. But national leaders are squabbling over what those actions should be.

German Chancellor Angela Merkel’s government on Tuesday rejected calls for it to boost spending and delay its goal of a balanced budget next year amid mounting evidence of a
slowdown in Europe’s biggest economy. Officials in Berlin also said they see no need for the ECB to try out new and uncertain measures.

Meanwhile, France and Italy are moving far more slowly on economic overhauls—such as shaking up rigid labor-market rules and cutting red tape for businesses—than Germany and the ECB want. But they are lobbying for the central bank and Berlin to help more with lack of demand in Europe’s economy.

“My fear, which is shared by many, is that if we don’t adapt (the eurozone’s economic policies) we will end up in an extended period of…very low growth and very low inflation,” French Finance Minister Michel Sapin told reporters on Monday night as eurozone finance chiefs met in Luxembourg.

“We risk entering a period a la Japan that would do a lot of damage to our economies and…our budgets,” he said, alluding to Japan’s long years of deflation and feeble growth, which—despite differences between the two cases—are often discussed in Europe as a warning for the Continent.

German Finance Minister Wolfgang Schäuble hit back at calls for Berlin to boost public borrowing and investment, which he faced during last week’s International Monetary Fund meeting in Washington. “The worst thing we could do would be to repeat yesterday’s mistakes” of relying on public debt to lift growth, he said Tuesday. Germany said that it expects growth of only 1.2% this year and 1.3% next, down from previous forecasts of nearer 2%. Slower growth “isn’t pleasant or particularly great, but it’s no reason for any crisis talk,” he said.

Mr. Fratzscher said he is “relatively pessimistic” that Germany will change course or that France and Italy will revamp sections of their economies more decisively. Political will for change “only appears when one’s back is against the wall,” he said.
Quiescent government bond markets in the past two years have removed the sense of urgency from Europe’s debates about overhauling its struggling currency union, after bond-market runs between 2010 and 2012 threatened to tear the eurozone apart. Although that danger has subsided, the bloc’s economy has failed to recover from the post-2008 financial crisis and recession.

Nearly no growth, double-digit unemployment and annual inflation that reached a new low of 0.3% in September show that the eurozone is suffering from a lack of demand on top of its many supply-side problems in regulation, taxation, banking and other areas.

With inflation far below the ECB’s target of just under 2%, financial markets believe the bank will eventually have to buy securities, including government bonds, on a large scale, a practice known as quantitative easing.

Some ECB officials fear quantitative easing would be less effective in the eurozone than in the U.S. or U.K., because of the currency bloc’s fragmented financial system, its reliance on bank loans rather than capital markets, and the fact that eurozone sovereign bond yields are mostly low already. But the ECB may have little choice but to try if inflation expectations continue to dwindle and the risk of outright deflation increases.

ECB President Mario Draghi and other central-banking officials believe such efforts stand a better chance of working if financially strong governments spend more, people familiar with their thinking say.

Mr. Draghi has suggested recently that the eurozone’s overall budget stance is too austere, given the weak state of the economy, and is warning that monetary policy can’t do the heavy lifting alone.

But his hints haven’t been welcome in Germany. A balanced budget was one of Ms. Merkel’s core re-election pledges last year and delaying it would be widely unpopular in the country. With unemployment low, even anemic growth puts little political pressure on the chancellor.

The Bundesbank, Germany’s finance ministry, and much of the country’s political class and business elite are also deeply skeptical about central-bank activism. Many Germans believe that current, historically low interest rates are already a risky policy, despite the lack of inflation.

Ms. Merkel has stayed out of the debates on monetary and fiscal policy, declining to give Mr. Draghi the political cover for radical steps—unlike in 2012, when she tacitly backed his promise to do “whatever it takes” to shore up bond markets and save the eurozone.

“The ECB’s position has been made much harder by the eurozone employing pro-cyclical fiscal policies” of spending cuts and tax increases that have weighed on growth, said Simon Tilford, deputy director of the Center for European Reform, a nonpartisan London think tank.

The politics preventing a coherent eurozone policy effort “look formidable difficult,” he said. “If they don’t act, we’re looking at another eurozone recession, and beyond that a long stagnation, rising debt ratios and worsening deflation pressures.”

—Gabriele Steinhauser contributed to this article.

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