Future Europe

A plan to tackle Europe's debt mountain

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The eurozone crisis has demonstrated the urgent need for tougher and more effective rules, says *Wolfgang Schäuble.* He sets out how EU countries can cut their deficits in growth friendly ways

The collapse of Lehman Brothers in the autumn of 2008 triggered the most serious financial and economic crisis in 80 years. The crisis in financial markets was contained only when central banks provided liquidity to financial institutions that were under duress, and when governments stood by with capital support and guarantees. The recession was cut short as governments, notably those of industrialised nations, offset falling demand by the private sector with unprecedented fiscal stimuli.

To borrow Hamlet's words, "thus bad begins and worse remains behind". A result of the unprecedented worldwide deficit spending is that the world economy appears to be returning to robust growth, but governments, i.e. the taxpayer, are being stuck with the bill. The IMF estimates that the net cost of financial sector support by G20 countries amounted in 2009 to 1.7% of GDP ($905bn), while the discretionary fiscal stimuli amounted to 2% of GDP in both 2009 and 2010. All the eurozone countries except Luxembourg and Finland reported a deficit in excess of 3% of GDP in 2009, while Greece, Spain and Ireland ran budget deficits of more than 10%. Within a single year eurozone governments' general debt increased by almost 10 percentage points (78.7% of GDP in 2009, compared with 69.3% in 2008). Ten eurozone members out of 16 reported debt ratios above 60% of GDP, while Greece and Italy now have debt ratios well above 100%.

As for Germany, its federal budget for 2010 features a record-setting deficit of over €65bn. This year, one out of five euros spent by the German government will have to be borrowed – another record. Meanwhile, public sector debt will surpass €1,700bn, approaching 80% of GDP. Interest payments consume 12% of Germany's federal budget, and this percentage will grow because of the mounting debt burden and – possibly – rising interest rates in the future. No society can withstand such a drain on its resources in the long term.

And yet the financial crisis and the ensuing recession only go so far towards explaining these high levels of indebtedness. The truth is that a number of European and G20 countries have over the past decades lived well beyond their means. This is even true of Germany despite the fact that it is often considered a paragon of fiscal rectitude.

The additional debt burden of recent years was just the last straw to break the camel's back – albeit a rather heavy one. Even in good times, governments have for too long been spending more than they earned. Perhaps worse, some also spent more than they could easily repay, given their economies' declining long-term growth potential because of the ageing of their populations. The profligacy of governments has led to levels of debt that will become unsustainable if we do not at once begin to reduce them. Not to do so risks seriously compromising our ability to shape our future, and will also prevent our children and grandchildren from shaping theirs.

If we continue this path, we are going to be hoisted with our own petard. This is why Germany decided in 2009 to enshrine strict fiscal rules into its constitution. The Schuldenbremse, or 'debt brake', requires the federal government to run a structural deficit of no more than 0.35% of GDP by 2016, while Germany's regional states will be banned from running any structural deficits at all as of 2020. The current federal government will certainly abide by these rules, and that implies reducing the structural deficit from about €53bn in 2010 to approximately €10bn by 2016 – a reduction of more than €7bn a year.

This is going to be no easy task, particularly as this government made a conscious decision to increase spending on education and research while not raising taxes on a large scale. It's a matter of fact rather than faith that only sustainable growth via long-term productivity gains and reduced deficits can increase employment, secure public revenues and raise living standards. The challenge we face is not so much to repair public finances but to do so in such a way that encourages rather than hinders future growth.

We have consequently been looking carefully at areas where savings could strengthen the economy's growth potential. The result is a fiscal plan that will reduce the federal deficit by an accumulated €80bn up to 2014. Roughly half these savings will come from the spending side because cutting expenditure offers much better prospects for growth than raising revenues. This focus on cutting expenditures is the key difference between Germany's current course and its previous consolidation efforts.

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When tackling expenditure, moderate savings in welfare spending as well as labour-market reforms are a necessary part of any sustainable fiscal-consolidation plan. Welfare benefits of more than €170bn account for over half of Germany's €320bn in federal spending this year. There is little choice but to cut federal welfare spending, at least moderately, if we are to contain government expenditure in any meaningful way. But this sort of fiscal consolidation can only be achieved if a majority of the people perceive it as socially equitable. Everyone must contribute, and that means recipients of social and corporate welfare and civil servants too.

Hence by 2014 we will not only be saving up to €10.9bn annually in welfare spending, particularly on unemployment benefits, but German corporations will also have to contribute up to €7.5bn a year to fiscal consolidation through reductions of subsidies and by additional taxes on major energy companies, airlines and financial institutions. And the public sector will likewise have to contribute its fair share; at the federal level, administrative costs are going to be reduced by around €4bn a year, and by 2014 10,000 jobs will have to go. Civil servants must forego promised pay increases, and the government is looking for annual savings in the federal armed forces of up to €3bn through structural reforms.

With the fiscal contraction resulting from our consolidation efforts totalling less than 0.5% of GDP, our measures are moderate in scale but economically sensible because they will prune social spending, increase incentives for the jobless to find work, reduce subsidies and trim the civil service. The measures are fully in line with the G20's commitment to gradually reducing our economies' dependence on deficits.

Germany's policy of expansionary fiscal consolidation by means of binding fiscal rules is setting a positive example for other eurozone countries, but that alone won't suffice. All the eurozone governments need to demonstrate convincingly their own commitment to fiscal consolidation so as to restore the confidence of markets, not to speak of their own citizens. Recent studies show that once a government’s debt burden reaches a threshold perceived to be unsustainable, then more debt will stunt not stimulate economic growth.

The recent turmoil suggests that this finding holds true for eurozone countries too. Greece’s debt crisis and the more general crisis it spawned was a clear warning that European policymakers must not allow public debt to pile up indefinitely. It was a graphic demonstration of how markets can suddenly withdraw their support for governments when deficits and debt reach levels that investors consider unsustainable. It would be grossly negligent of European policymakers to ignore these warnings, as markets could permanently lose confidence in the eurozone countries’ ability to service their debts, leading to citizens loosing their confidence.

The financial, economic, social and political ramifications of such a debt crisis would be dramatic and difficult to contain. The EU was therefore right to react swiftly and decisively to secure the stability of the euro by providing short-term assistance to Greece and establishing a European financial stabilisation mechanism. But even though the EFSF is a necessary step towards stabilising the current situation, the crisis in Greece has revealed structural weaknesses of the European Monetary Union’s fiscal policy framework that cannot, and should not, be fixed by routinely throwing other countries’ money at the problem. I consider the EFSF to be just a stopgap while we hone the tools and remedy the fundamental shortcomings of the Stability and Growth Pact.

It is worth quoting the IMF in this context “The current crisis is a wake-up call for the euro area”, it said, “largely caused by unsustainable policies in some member countries, and has put the spotlight on the deficiency of area-wide mechanisms in disciplining fiscal and structural policies.” It is now clear that EMU’s current rules are insufficient to impose enough fiscal discipline on eurozone members and to prevent crises. The EU is also ill-equipped to deal with sovereign liquidity and solvency crises when they do occur. In brief: The eurozone’s fiscal rules lack bite in both substance and form.

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This is why we need a more effective crisis-prevention and crisis-resolution framework for the eurozone through the strengthening of the preventive and corrective arms of the Stability and Growth Pact. Sanctions for eurozone countries that seriously infringe EMU rules should not only take effect more quickly and with less political discretion, but need to be tougher. Germany and France have proposed stricter rules on borrowing and spending, backed by tough semi-automatic sanctions for governments that do not comply. Countries that repeatedly ignore the recommendations for excessive-deficit reduction and those that manipulate official statistics should have EU funds frozen and voting rights suspended.

But it is not only countries that need incentives to borrow responsibly. Investors too need incentives to encourage them to lend responsibly. Any future crisis-prevention and crisis-resolution framework must provide for private-sector participation in the resolution of sovereign-debt crises. Such a sovereign-debt restructuring framework should of course be focused on newly-issued sovereign bonds only, but a restructuring framework we need.

For those who may find such a framework objectionable, it is worth remembering that monetary union was not intended to be a panacea for eurozone members, or for that matter a get-rich scheme for financial speculators. Nor was it meant to be a system of redistribution from richer to poorer countries via cheaper borrowing for governments by means of common Eurobonds or outright fiscal transfers. European Monetary Union won’t succeed if some countries persistently run deficits and weaken their competitiveness at the expense of the euro’s stability.

EMU was in fact designed to encourage structural reforms. Profligate members were supposed to be forced by the rules of the Stability and Growth Pact, as well as by their peers, to live within their means and strengthen their competiveness. Instead, Germany’s former social-democratic government weakened the pact when that was politically convenient, while less competitive members of the eurozone allowed wages to rise and the public sector to become bloated and then looked the other way as easy credit fuelled both debt and asset bubbles.

To return to Hamlet, sometimes it seems cruel to be kind. We won’t foster sustainable growth or pre-empt a sovereign-debt crisis in Europe or anywhere else by piling-up yet more debt. European countries need to reduce their deficits in a growth-friendly fashion, but reduce them they must. And it can be done: Germany is reducing its debt burden to sustainable levels while strengthening its long-term growth prospects. Its course of growth-friendly deficit reduction in conjunction with its suggestions for a strengthening of Europe’s fiscal framework could serve as a blueprint for European economic governance. So, let Europe take arms against a sea of troubles. And by opposing end them!