A plan to tackle Europe's debt mountain

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 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 well above €50bn. This year, almost 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 their ageing 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.

COMMENTARY

By **Loukas Tsoukalis**

Schäuble's "Hamlet scenario" risks similarly heavy casualties among the actors

It's been a difficult year for Europe, for the euro and even more so for my own country, Greece. The Greek debt crisis sparked-off a crisis of confidence in Europe's single currency. Of course, most of the blame lay with the Greeks themselves: a large budget deficit, added to an already huge public debt, an unsustainable current account deficit coupled with a credibility deficit when previous governments were found to have been economical with the truth. Markets typically over-reacted, seeing Greece as a precursor of things to come in other vulnerable eurozone countries. And the system of euro governance was found wanting. It took us all rather long to respond, and the delay cost us dearly. As so often, Europeans reacted just a few steps short of the brink, but we are still nowhere near the end of a painful adjustment to the post-bubble world.

Greece is now going through a tough process of budgetary consolidation that aims to reduce budget deficit by almost six percentage points of GDP in 2010, accompanied by ambitious structural reforms. The rescue programme, with strong conditionality, stretches ahead to 2013. The political will is there, and the record so far is encouraging, winning praise from EU institutions and the IMF who are monitoring the programme. Measures that were simply unthinkable only a short time ago are now

If we continue along 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.

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

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.

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

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being implemented. But as there is more to come, it will be a difficult test of Greece's political, economic and social endurance.

The eurozone crisis is acting as a catalyst for deeper integration, so we are likely to end up with stronger and more effective governance structures for the euro. These will include closer co-ordination of national fiscal policies and broader economic ones too, backed up by the threat of sanctions and by more effective surveillance procedures, greater emphasis on structural reform and, hopefully, with a more permanent mechanism for crisis management. The general direction is good, although divergences persist among member states.

The devil surely lies in the detail of implementation. Provisions for closer co-ordination of national economic policies do not automatically resolve the problem of who actually sets the priorities, both for the eurozone and the EU as a whole. Closely related to it is the old problem of distributing the burden of adjustment between surplus and deficit countries.

What then, in today's context, would be the correct timing for so-called exit strategies, and what is the appropriate pace of fiscal consolidation for European economies still taking their first, hesitant steps towards recovery? Governments are increasingly constrained because of rising debt, while financial markets are as imperfect and short-sighted as ever. To borrow from an old Greek myth, navigating between Scylla and Charybdis requires skill and determination, but it's where we find ourselves today. We should also remember that intergovernmental co-ordination has its limits. The role of the EU policymakers to ignore these warnings, as markets could permanently lose confidence in the eurozone countries' ability to service their debts, leading to citizens losing 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.

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 first we need a restructuring framework.

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! □

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institutions and their instruments has to be revisited, and the time has also come to think out of the box about the EU budget.

Germany is, of course, absolutely crucial as Europe's largest economy and with a big current account surplus with the rest. 'Expansionary fiscal consolidation', as Wolfgang Schäuble puts it, coupled with the inherent dynamism of the German economy, may indeed help to pull Europe out of the biggest recession we have experienced for decades. But Schäuble quotes from Hamlet, and we should remember that Hamlet's story ends up with far too many deaths. We wouldn't want to repeat that experience, nor wait for a post-mortem to find out whether his prescription is right. □

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Designing a new institutional architecture for the eurozone

There's no reason to worry about the future of the euro, says European Central Bank board member Jürgen Stark. But there's every reason to re-design and strengthen the eurozone's rules and sanctions

The current economic policy debate to a large extent concerns the future of the euro, yet I myself have no concerns about its future. There can be no question about the success of the euro in terms of price stability; the inflation rate is moving in line with price stability, as has been the case, on average, for the past 11½ years. That means inflation has been lower than in the best-performing eurozone countries in the decades before monetary union – not to mention in many of the other European countries.

The outbreak of the financial crisis in 2007 caught many people on the wrong foot. Yet the crisis of public finances that we now find ourselves in should really have come as no surprise to anybody

So we are not, as many commentators suggest, dealing with a crisis of the euro. We are dealing with a sovereign debt crisis and the consequences of inadequate economic reform in the eurozone. And the problem of overly high levels of public debt is not just a eurozone problem but one encountered in virtually all other industrialised nations.

Eurozone countries now need to draw firm conclusions from the current crisis. They need to fundamentally re-work and strengthen the institutional architecture for co-ordinating the lo[illegible] overdue structural reforms and for safeguarding public finances. Instead of continuing to deny the fact that membership of a monetary union also limits the sovereignty of national economic and fiscal policies, eurozone members must finally come to terms with economic reality and follow stricter budgetary rules. To this end we need a de-politicisation of fiscal and macro-economic surveillance, stricter and more binding rules, a better and more automatic recourse to sanctions for breaching the rules and the stringent co-ordination of economic policies.

In these turbulent times, the euro has acted as a protective shield for countries that would in comparable circumstances have been plunged into a deep currency crisis. Perhaps too much so, because in contrast to before these imbalances were neither mitigated nor sanctioned by rising yields in the financial markets. On the contrary, despite massive imbalances and huge disparities in the level of private and public debt across the eurozone the differences between the yields on the respective government bonds had disappeared completely in the run up to the crisis. This development demonstrates either a flagrant misapprehension of risk on the part of market participants – including ratings agencies – or that investors as a whole never took the no bail-out clause seriously.

The outbreak of the financial crisis in 2007 caught many people on the wrong foot. Yet the crisis of public finances that we now find ourselves in should really have come as no surprise to anybody.

The institutional architecture that has been put in place for the co-ordination of economic and fiscal policies was never implemented. On the fiscal policy side, the rules of the Stability and Growth Pact were even weakened.

The decisions on adjustment measures and on possible sanctions were made far too dependent on short-sighted political and electoral considerations. As long as potential "sinners" continue to judge de facto "sinners",

COMMENTARY

By Jacques Mistral

Let's hope the new eurozone rules will make it the world's best managed currency

The spectre of sovereign default is back. The roots of this year's sovereign debt crisis go deep, and can be found in all the industrialised countries. Those fears have so far centered around Greece because Greece has been the worst offender. Investors may be repelled by the political economy of the eurozone, but to conclude that the eurozone is dying is quite simply wrong. So I share Jürgen Stark's main point; one need have no concerns about the future of the euro.

This crisis has forced European governments to recognise the design flaws of the monetary union, and they have responded accordingly. Yes, a new architecture for the euro area is on the horizon, and a new policy framework is emerging that will be based on stricter fiscal stability rules and on crisis prevention and management mechanisms. Jürgen Stark wisely summarises the two goals that eurozone countries have to attain; reducing deficits and indebtedness to sustainable levels, and restoring the competitiveness of individual countries so as to eliminate, or at least reduce, imbalances.

I would add another important point: The most basic tool of this new architecture will be sound statistical information and sharp financial reporting. The failure to recognise in advance the dangerous path adopted by Greece is at the origin of the trouble. So an peer pressure will not work. Consolidation programmes were all too often founded on overly optimistic growth assumptions. In times of robust economic growth, debt reduction was neglected. Reliable statistics were not available in all countries, and in addition, there was for 11 years no political will to introduce reforms to protect public budgets against the consequences of increased pension commitments due to the rapidly ageing population.

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All these failures to act became fully manifest in secondary legislation, when in 2005 European governments watered the rules of the Stability and Growth Pact down to a degree that made them to all intents and purposes optional. At that time, the ECB was highly critical of this erroneous decision, and now its dramatic economic and financial consequences have not only borne out our greatest fears but have even exceeded them.

The financial crisis has, meanwhile, hit fragile public budgets with full force. The effect of automatic stabilisers in the economic downturn, the state support for banks as well as the fiscal stimuli adopted by governments all undermine the sustainability of public finances. Financial assistance of a hitherto inconceivable magnitude has been made available in the eurozone, in co-operation with the IMF, so as to prevent contagion effects leading to a complete breakdown of trust in the financial markets.

The sudden reappraisal of the situation by the financial markets has put governments under considerable pressure to adopt measures to reduce their deficits. But there is a risk that these efforts will wane as soon as a degree of deficit reduction has calmed financial markets down. If this were to occur, high public debt will become permanent. Euro area countries need to fundamentally re-work and strengthen the institutional architecture for co-ordinating long overdue structural reforms and for safeguarding public finances.

These efforts will require far-reaching institutional reform. What is required is a de-politicisation of surveillance, stricter and more binding rules, a better and more automatic recourse to sanctions for breaching the rules and a stringent co-ordination of economic policies.

The de-politicisation of surveillance is best achieved by creating an independent body, formal or informal. Budgetary rules must be strengthened, and we need stricter and more automatic recourse to sanctions in cases where the rules are being violated.

Stricter and more binding rules also demand a stronger link between deficit and debt criteria. Reducing the present high debt levels will require substantial consolidation efforts. First, governments should bring fiscal deficits down to below

3%, in line with what has been agreed by the European Council. Second, to set extraordinarily high debt ratios back on a diminishing path, governments will have to aim at reducing deficits further in line with their medium-term budgetary objectives.

Sanctions must be made credible. They must come into play long before a country falls into economic difficulties, and they should therefore not be purely financial in character but should include suspension of voting rights. And these sanctions must begin to be imposed when governments fail to meet minimum requirements for attaining medium-term objectives and must then become incrementally more severe the longer and the more seriously the rules are contravened.

Where structural policy is concerned, we need a better architecture for overseeing and safeguarding the competitiveness of individual countries, and for eliminating imbalances. This calls for competitiveness to be monitored, and made subject to surveillance, perhaps on the basis of trends in unit labour costs.

On the basis of this process, countries should be assigned to different risk groups in line with their economic vulnerability. The higher the risk, the more binding the recommendations for the reduction of imbalances, and also the stricter the surveillance of the implementation of measures and then the possible imposition of sanctions.

One of the options put forward as a possible innovation is the establishment

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independent body to exercise multi-lateral surveillance would be an excellent innovation. A German-style "wise men's committee" could be a lean yet influential body, even though it might encounter difficulty finding a place in the already complex European architecture. Perhaps some sort of bi-partisan Parliamentary Budget Office in the manner of the American CBO, but with a stronger mandate, would have the major advantage of involving the European Parliament. In any case, different solutions should be evaluated quickly and be made part of the Van Rompuy proposals.

On the basis of sound financial information being furnished by every country, a more stringent implementation of rules and procedures will ensure the correction of excessive deficits. National fiscal frameworks will have to conform to a blueprint of good practice, and so long as public and private ratings agencies are providing correct information, then financial markets can do their job. Spreads in the markets will ensure that commitments to fiscal prudence are the primary concern of national parliaments.

I would not use the term "sanctions" as it does not even belong to the IMF's vocabulary. Budgetary discipline has to be endorsed by democratic institutions, and parliaments have to face financial realities. I would in this regard first and foremost rely on mechanisms like IMF reporting, the European Central Bank reports, independent evaluations, peer pressure within the Eurogroup and ratings agencies, all of which will translate into spreads that we now know can be discouraging enough to place serious limits on perilous national economic policies. If needed, the next step would be "conditionality" of a new institution for crisis management, which would most likely require a treaty change. If the institutional reforms in the realm of fiscal policy and the co-ordination of economic policy are successful, such an institution would never need to take action, and would thus be redundant.

To ensure economic success and political cohesion in the monetary union we need far-reaching reform of the institutional architecture to safeguard the sustainability of public finances and eliminate imbalances. Swift and sound solutions are therefore required that would fall short of treaty amendments.

The world's industrialised nations have now been playing for time for more than three years, but running up even higher debts is not an option. The only course is debt reduction accompanied by a rapid and fundamental restructuring of the economic and financial system so as to support growth and employment.

Over the last decade, certain eurozone countries have gambled away their competitiveness through excess. To restore their competitiveness and eliminate imbalances, prices and wages in these countries must decrease in relation to prices and wages in the eurozone as a whole. This is

EUROPE'S WORLD BACKGROUND BRIEFING

The eurozone crisis hasn't blunted the EU newcomers' desire to join

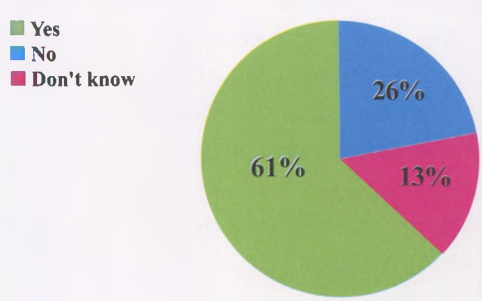
As Europe's leaders grappled to find common cause on the eurozone crisis, a survey found the single currency's reputation relatively untarnished in the eight new EU member states.

Citizens in Estonia, Lithuania, Latvia, the Czech Republic, Hungary, Poland, Romania and Bulgaria were asked in May on the impact they thought the euro's introduction might have in their own country. Some 49% thought that introducing the euro would be positive, down from 55% a year ago, and 37% felt that it would be negative.

Two-thirds believed that prices would rise if the euro were introduced, but 61% felt that Europe's place in the world would be enhanced if their country were to join the eurozone. Perhaps more surprisingly, 46% thought that introducing the euro would lead to sounder public finances, compared to 36% who disagreed.

The most widely held fear regarding the single currency's introduction concerned abuses and cheating on prices during the changeover. In contrast, a majority said they did not fear the loss of national control over economic policy or the loss of national identity.

Do you think the euro will reinforce the position of Europe in the world?



Source : Flash Eurobarometer No 296, 2010 quite simply the form the adjustment process must now take in the eurozone. And it will not give rise to the danger of deflation for the eurozone as the ECB will make sure of that.

These adjustment measures are painful but necessary. Without structural reforms to strengthen employment and growth, even the most earnest efforts to save will come to nothing both economically and politically.

Structural reforms and budgetary consolidation measures are, incidentally, not tasks only for countries with a current account deficit. These are, of course, the countries where the pressure to take action is particularly high, but others with a current account surplus also have to adopt measures to strengthen the domestic economy by creating incentives for investment and employment. We must not forget that there is no country in the eurozone whose budgetary situation can be described as lastingly sound.

Europe has been going through the worst crisis since World War II, but it's worth remembering that European integration has always been driven forward after a setback or crisis. If that were not the case we would not now have the single market and a common currency. Crises, by their very nature, are turning points, and European policymakers have clearly begun to recognise that it is high time to take action. So there are reasons to be very confident that Europe as a whole will emerge stronger from this crisis, with buttressed stricter rules and reformed institutional structures. □

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COMMENTARY

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regarding the disbursement of EU funds, and the new framework should set out an operative procedure defining this. At the same time, I would strongly oppose the idea of suspending voting rights because in a democracy even a bankrupted citizen is not deprived of their political rights.

A very important point raised by Jürgen Stark relates to deficit and surplus countries now being so inextricably intertwined. There can be no deficit country without there also being a surplus country, and ironically this is what Chancellor Merkel finally recognised when she told her fellow Germans that rescuing Greece was in the best interest of Germany's own savers and tax-payers. Ever since John Maynard Keynes proposed the new international monetary system back in 1944, we have known that symmetrical adjustments of current imbalances are the most desirable mechanism, so Stark's suggestions regarding this certainly deserve to be developed further.

The present crisis is far from over, so the relevant European authorities have to both consolidate economic recovery and at the same time create a stronger financial basis. What we are now awaiting from the Van Rompuy task force and from the Council is a significant step towards a new and stronger architecture. The decisions that must be made in the coming months offer a very real opportunity for the eurozone to become the "best managed" in the world. □

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The strategic consequences of the eurozone crisis

The malaise afflicting Europe's single currency is damaging the EU's global standing and its ability to act, writes Charles Grant. And it's a crisis that will be with us for years to come

The euro crisis will be with us for many years. The underlying causes, such as southern Europe's lack of competitiveness, cannot be remedied overnight; Greece, Italy, Portugal and Spain face years of low growth, severe curbs on public spending and perhaps social unrest. Many people on other continents now wonder whether the euro is forever, and they also think the EU's hesitant and discordant response to the Greek debt crisis raises questions about the quality of Europe's leadership.

The euro's malaise is damaging not only the EU's global standing, but also its ability to act effectively, in at least four ways.

First, the arguments over how and when to bail out Greece and other countries that may need help have worsened an already fraught relationship between France and Germany. There have been differences of personality and of economic philosophy, with France's impulsive President Nicolas Sarkozy and Germany's dour Chancellor Angela Merkel seeming to wind each other up. At times Herman Van Rompuy, the European Council president, has had to beg them to talk to each other.

The Germans have pushed for stricter rules on budget deficits, with severe penalties for countries that borrow too much. They have even talked about a new treaty that would allow for miscreants to be expelled from the eurozone. But the French have emphasised the need for governments to discuss each other's policies and performance as well as imbalances within the eurozone. The French government opposes a new EU treaty, and Paris and Berlin have also clashed on whether to involve the IMF, on whether the European Central Bank (ECB) should buy governments' bonds and on whether the key forum for economic governance should be the euro group or the wider EU.

It is true that at each stage of the crisis France and Germany have in the end found a compromise – which they have then obliged the other member states to swallow. But the coolness between Merkel and Sarkozy matters. The EU can achieve very little – including in foreign policy – without France and Germany working together effectively.

Second, the Greek crisis has highlighted Germany's growing isolation within the EU. Ever since reunification, Germany has gradually been asserting its interests more forcefully, in the way that Britain and France always do. In an enlarged EU of 27 members, Germany's leaders no longer assume that what is good for Germany is good for the EU, and *vice versa*. On issues like energy and Russia they have sometimes opposed a common EU position on the grounds that Germany's own interests could be harmed.

This year, many member states – and the European Commission too – have criticised Germany for not doing more to stimulate demand in the eurozone, and thus help the southern Europeans to grow at a time when they are slashing public spending. German politicians respond that higher domestic consumption would do little to help southern Europe, and that public opinion in Germany constrains them from aiding profligates. Many Germans feel they are being asked to become less competitive. They are not entirely on their own in these arguments; the Dutch, the Finns and then Austrians all support the German emphasis on budgetary discipline. But a lot of Germans, hurt by criticism that they regard as unfair, are keen not to subordinate their interests to those of 'Europe'. Never before in the history of the EU has Germany been so disconnected from most of its partners.

Third, the euro crisis has weakened the Brussels Commission, whose power – relative to EU member governments – has been in slow decline for about 20 years. When the financial crisis struck in 2008, it was the larger member states that led the EU's response, partially sidelining the Commission. And though the Commission helped to design the €500bn package agreed in May of this year, the EU governments will control the largest pot of money, the European Financial Stability Facility. The IMF and the ECB will play a role in setting the conditions that apply to those borrowing from the facility.

In Paris and even more in Berlin there is growing contempt for the Commission. They accuse it both of interfering in too many areas and of failing to lead during the crisis. The Commission responds that its job of policing competition policy inevitably upsets the big members, and that the national capitals often do their best to prevent Brussels from taking the lead. The Commission's job is to promote the wider European interest, so the weaker it becomes, the greater the danger of governments pursuing their particular interests, to the cost of the EU.

Fourth, the euro crisis is making the EU introspective. For the past ten years the emphasis on treaty change has forced European leaders to spend too much time and energy on institutions and procedures. Many had hoped that with the Lisbon treaty out of the way, the EU would at last focus fully on big global challenges like Russia, China, energy and climate. But the EU's hesitant and muddled response to the Greek debt crisis has set off a game of mutual blame. Europe may have to endure several years of emergency summits and bail-outs, sowing discord and undermining trust between the member states.

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- *The consequences for Europe of the global crisis by Rob de Wijk*

None of this means the euro or the EU will fall to pieces. For all their imperfections, Merkel and Sarkozy are the best leaders Europe has got and they will find ways of working together. Germany will in the end do what is necessary to keep the euro stable, and EU governments will grudgingly accept that they need the Commission. Crises on other continents will also force EU leaders to raise their eyes to the wider world.

Nevertheless the EU's uncertain handling of the euro crisis has greatly tarnished its soft power. Key people in Washington, Moscow, Beijing and New Delhi have become even more dismissive of the EU than they already were. So what can the EU do to limit the damage and revive its global reputation? To begin with, the Union needs to fix its economy. For decades Europe has grown more slowly than other continents. The remedies required are well-known – they were set out in the Lisbon Agenda that was agreed in 2000 and have now been repeated in the Commission's recent EU 2020 programme. But too few governments have embraced structural reform. The southern Europeans have a particularly poor record, which accounts for some of their present travails. But constraining public spending is not enough; many EU states also need to liberalise their labour markets, reform universities and schools, remove red tape, modernise pensions systems and create the conditions which encourage entrepreneurialism and innovation. This summer, the Greek and Spanish governments have appeared – belatedly – to be taking some of the right steps.

The EU's governments need to agree on major reforms to eurozone governance. The broad lines are fairly clear – stricter budgetary discipline, more mutual surveillance of economic policies, and a mechanism for dealing with governments that need to restructure debt (as Greece will probably have to do). Such changes do not require a new EU treaty, which in any case most EU governments oppose. Some eurozone banks will probably need to be recapitalised.

Germany needs to accept that eurozone governments will have to discuss imbalances in the euro area; but Germany's partners should relent in their urging of Germany to reflate, which might be counter-productive. Rather, they should ask Germany to embrace structural economic reforms that would in the long run lead to a more balanced economy. Many German economists know that the country needs to shift away from dependence on exports towards higher levels of domestic consumption. Longer shopping hours, labour market reforms that encourage employers to take on staff (and thus raise the cost of labour) and better childcare so that more women work would all boost spending.

The EU's 'big three' countries also need to work together in ways that convince the rest of the world that Europe has serious leaders who will do what it takes to stabilise the eurozone. Although Britain is outside the euro, what Britain says and does plays an important role in shaping global perceptions of the EU. Prime Minister David Cameron has made a good start by adopting a constructive attitude to the EU. He has made it clear that he understands it is in the British national interest for the eurozone to overcome its difficulties.

Germany's leaders need to do much more to educate people on the benefits of the euro. The business and political elites know that the eurozone provides German exporters with a large market of rather uncompetitive countries that buy their goods. Yet many Germans believe the euro is a burden. Merkel must explain that Germany is paying into the bail-out funds not for idealism or altruism but out of self-interest.

France and Germany need to avoid public squabbles and revive their close alliance, so Merkel and Sarkozy must learn to tolerate each other's foibles. France will have to accept more binding rules and budgetary discipline than it would wish, while Germany will have to tolerate group discussions of its economic policy. Germany will also have to accept that if Northern Europeans cannot provide the demand that helps to pull the southern states out of a vicious circle of slow growth and public spending cuts, they will have to cough up for the transfer payments required to hold the eurozone together.

In Brussels, much energy has gone into building the new External Action Service, in the hope that it will foster a more coherent EU foreign policy. Let us hope that it does. But what would really improve the EU's global standing would be strong economic growth, a convincing set of rules for the eurozone and the perception that Europe has tough and far-sighted leaders. □

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The European economy isn't dying, but it is being put to sleep

Former Danish Prime Minister Poul Nyrup Rasmussen, who as an MEP is now President of the Party of European Socialists, warns that conservative policymakers' dogma risks putting the EU economy to sleep for years. He prescribes the antidote

Is the European economy dying, as some commentators on the eurozone crisis suggest? No, it's not dying, because the European Union is still the biggest and richest trading bloc on the planet. There are certainly no fears among investors or service providers even of a terminal decline. Perhaps the more accurate question we should ask is whether the European economy in danger of an unwanted, enforced period of sleep? The Party of European Socialists (PES), of which I am President, would contend that the conservative right is in danger of being the doctor that administers this enforced sleep. I refer, of course, to the almost unprecedented austerity drive that conservatives have called for across the European continent.

When austerity measures begin to be implemented by countries in sound economic health, one has to ask whether these measures are nothing less than a conservative assault on the welfare state

A stark choice faces Europeans between a discredited ideology called neo-liberalism and a balanced long term approach called social democracy. Adherence to such neo-liberal tenets as loose rules led us to the carnage of the global financial crisis. And now through this austerity drive, its advocates are now trying to dump both that carnage and the accompanying 'blame tag' on "the state". But to follow instead a social democratic path would mean stopping this folly. And that in turn would mean that Europeans could see the value of strong regulations and a mutually reinforcing relationship between state and enterprise.

The present 'cuts only' approach under the political leadership of Germany's Chancellor Angela Merkel, and with the backing of France's President Nicolas Sarkozy, who seems incapable of articulating an economic alternative, runs the risk of putting the European economy to sleep for months and maybe even years. And when austerity measures begin to be implemented, too, by countries in sound economic health, one has to ask whether these measures are nothing less than a conservative assault on the welfare state.

The proposals for a very different approach being put forward by the PES want to keep the economy vibrant, alert to new possibilities based on innovation and, above all, founded on the principle of long-term investment. The conservatives' insistence on withdrawing public support through so called 'exit strategies' would to my mind pull the rug from under the feet of economic recovery. It is not so much a strategy as a violent wrench on the foundation of the welfare state.

So what would we in the PES do differently? Our first departure from this conservative ideology of bludgeoning your way to economic health is to take what we believe is a more balanced approach. Yes, there is a need for responsible budgetary policy, but it must go hand-in-hand with a clear commitment to public investment whose laser-like focus is on the one criterion of recovery that matters most of all – job creation.

The eurozone crisis has certainly taught us all the lesson that a serious crisis requires serious action, but unfortunately that lesson was learned the hard way. Conservative inaction and the mixed messages of the early months of this year have been replaced by policies that are closer to their true nature. The austerity programmes demanded by Germany have been coupled with a

Commentary

By **Philip Booth**

A good example of a dangerous prescription from a wrong diagnosis

In economics, false policy prescriptions arise from false premises. This is one of many problems with Poul Nyrup Rasmussen's article. He argues that adherence to neo-liberal rules led to the financial carnage. It is difficult to believe that anyone familiar with both EU and international banking regulation or the millions of paragraphs of national regulation can seriously believe that it was neo-liberalism that led to the financial crash. Yes, there was bad regulation – the socialist regulatory approach certainly did fail – but it is not true that there was no regulation.

Closer to the truth is that U.S. corporatism created a tinder box in the banking system. Risk is underwritten throughout the U.S. financial system by the taxpayer. This arises from weak personal bankruptcy law; the state mortgage securitisation houses Fannie Mae and Freddie Mac; federal and state requirements to provide loans to poor risks; and the continual bailing out over several decades of financial institutions.

It is true that financial institutions made huge mistakes, but it is no wonder they made them given the incentives they had. Regulation and the tax system further distorted the decisions of banks, thus discouraging good risk management and encouraging gearing.

new sense of 'economic governance by menace'. The European Commission, taking its cue from Franco-German conservatives, has introduced a nasty new streak into European economic management. Rather than talking up the various possibilities for co-ordination, they have chosen to pander to fears of punishment. The recent Commission's proposal on "enhancing economic policy co-ordination for stability, growth and jobs" is spectacularly misnamed, for it should really be entitled "How to stifle job creation while deflating the European ideal of co-operation".

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The PES has a set of proposals that will get Europe working again and which constitutes a European new deal – one that is responsible, appeals to European citizens and that will strengthen our welfare states. This should not mean making short-term fiscal consolidation a priority at the expense of long term growth and job creation. Stronger and more vigilant surveillance regarding the public deficit and debt is to be welcomed, but the economic indicators that really matter are growth, employment and social cohesion. The conservatives do not seem to care how tattered the social fabric becomes as long as balance sheets look good. Strategic thinking, it is not.

The European Commission's concept of a 'European semester' of economic co-ordination is acceptable as such, but, again, only if it moves beyond the narrow parameters of fiscal consolidation. There must be a system in place which allows more time for member states to reduce their deficit, gives greater access to the instruments of the European Investment Bank (EIB), as well as to EU structural funds and to the joint-issuance of euro-denominated bonds.

The PES wants to break the taboo around countries with balance of payment surpluses. There is too often a knee-jerk 'surpluses good, deficits bad' argument. Countries such as Germany that habitually run surpluses need to recognise that they are part of a wider economy. Being part of this economic community gives an enormous market for their exports. To echo the point I have already made about the need for the state and enterprise to be mutually reinforcing, it is worth exploring the conventional wisdom that surplus is by definition good. Perhaps so, if an economy exists in isolation. But Germany does not, so there comes a moment when what may look like a responsible surplus becomes destructive hoarding.

It is not acceptable for labour to take yet more of the burden. Real sharing of the burden of fiscal rebalancing requires taxation on financial markets and on pollution. Such a policy should be aligned with the transition towards a greener, smarter and more inclusive economy. This should include green taxes and a financial transactions tax, which I'm proud to say the PES has done so much to keep on the political agenda.

On public debt management, there is an obvious need for the problems to be tackled, but we also need more solidarity. The joint-issuance of euro-denominated bonds – Eurobonds – should become possible, and the concept of a European Debt Agency must be seriously explored.

The European economy is not dying, but there is a very stark choice to be made. Do we want enforced sleep for the patient, or a period of long-term rehabilitation? Austerity programmes are the sleeping pills of our region's economy, whereas a programme of genuine economic governance, based on co-ordination, solidarity and the recognition of public investment represent the exercise programme needed to get the European Union economy back on its feet.

In sum, the policy proposals we at the PES are putting forward consist of a co-ordinated economic policy that recognises that the EU is a single trading area, and not a disparate collection of competing member states. They include a long-term 'Europe 2020' strategy that puts social justice, poverty reduction, green growth and jobs at the centre, reinforcing a sustainable way out of the crisis. We also advocate effective and urgent financial regulation that includes the strengthening of European supervisory authorities; more transparent and tighter control of derivatives products and speculative actors such as hedge funds and private equity; the regulation of private rating agencies and the creation of an independent European rating agency.

COMMENTARY

Philip Booth

To be fair to Poul Nyrup Rasmussen, this was not caused by socialism. But it is not neo-liberalism either. The "welfare state for bankers" has had predictable effects and has its roots in U.S. corporatism and misguided social policy.

Rasmussen also ignores the serious problems that have been caused by the growth of the state in recent years, yet he argues that cuts will put the EU economy to sleep even though there is simply no evidence for that. Fiscal expansions over long periods have failed to produce economic growth in Japan. Fiscal retrenchments, as the EU's own evidence shows, have quickly led to renewed economic growth. In many EU countries the growth of state spending has been relentless and structural – it has had nothing to do with the financial crisis. In Britain, the government now spends 54% of national income, and 25% of national income goes on welfare transfers. When is this policy going to succeed in dealing with dire problems like poverty, family breakdown and homelessness? Will it be when our politicians are spending 56%, 60%, 65% of people's incomes? The idea that a relentless centralisation and socialisation – taking power out of the hands of the people – will actually improve the condition of the people has been proven wrong time and time again.

Poul Nyrup Rasmussen suggests that we should move taxes from labour to financial institutions and the environment so as to lower the burden on workers. Socialists seem so obsessed with institutions that they totally ignore the fact that the burden of all taxes falls on people. There may be justifications for taxes on financial transactions or on carbon

There needs to be a clear response to the EU sovereign debt crisis, in which a system of Eurobonds managed by a newly created European debt agency handles existing debt, facilitates future debt management and protects against speculative attacks. This could provide relief to national budgets and be combined with clear political conditionalities to ensure sound economic and sustainable growth. If the EU had the capacity for the EU to issue Eurobonds, these could fund investment projects to be managed at European level. Finally, a European Employment and Social Progress Pact that would include concrete measures to create new jobs and promote active labour market policies could help improve the quality of work, fight precarious jobs and overcome social inequalities such as the gender pay gap, while improving access to public services. □

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emissions – though I do not support them. However, we have to recognise that such taxes are taxes on people. Carbon taxes are a tax on those who emit carbon (and the poor often emit proportionately more than the rich) and financial institution taxes are taxes on the workers and others who use financial institutions as well as on those who own them (generally pensioners, savers and insurance policy beneficiaries).

Ultimately, job creation can only come as a result of businesses producing the goods and services that real people want to buy. Jobs are not created by bureaucracies or by government borrowing. Still less are they created by wide-ranging welfare states. Social democracy has had its day. It is not a stable middle way: it is an unstable force gradually strangling the very people it is intended to help. □

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