Sustainable Growth for Europe:
The Four Crises and a Call for Reform

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Abstract In this paper, the authors demonstrate that the current crisis is based upon four different crises with different sources, which must all be solved in different ways. In addition to this, they highlight individual issues within individual European economies and in the current institutional set-up of the European Union. On the basis of this analysis they provide clear suggestions about what needs to be done to recover growth in Europe.

Keywords Sovereign debt crisis – Economic integration – Sustainable growth

Introduction

As Europe and other parts of the world suffer from economic recession, European policymakers have offered a number of ideas and concrete solutions to the crisis. While having the same aim of activating economic growth in Europe, some of these ideas call for completely different actions. In this article we will offer our views on how Europe can return to a path of sustainable growth.

In order to do this, ‘the crisis’ needs to be analysed in detail. One cannot talk about just one crisis since there are four different crises that have evolved for different reasons and in different regions: the financial crisis, including the banking crisis; the economic crisis; the sovereign debt crisis; and the political crisis in Europe. In the end, the different crises are interlinked with each other

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and their negative effects have spilled over into other economic sectors and into other countries. These crises have revealed issues in our national economies, imperfections in our regulation of the banking and finance sector, and imperfections in the economic and institutional set-up of the euro area and the European Union as a whole. Each crisis, therefore, must be tackled individually.

Structural reforms in the Member States are a precondition for sustainable growth. Furthermore, the possibility of future financial crises needs to be reduced to a minimum in order to achieve long-term growth. Keynesian models have proven to be inadequate during this recession. It is clear to us that sustainable growth cannot be achieved by excessive budget deficits and stimulus plans, since these can be an entrance into the vicious circle of the continuing indebtedness of states. Those countries with the lowest debt levels enjoy the highest growth rates. But the reasons for indebtedness are different in each country, although some are interlinked, with negative effects spilling over from other crises. A mutualisation of debt cannot be the solution for the sovereign crisis. Moral hazard was a decisive factor in different areas when analysing the different crises. Nevertheless, those countries willing to reform and increase their competiveness need financial assistance to smooth the negative effects of the painful adjustments and reforms.

At the EU level, many decisions have been made in order to combat moral hazard in the financial markets and at the national level. At the supranational level, the foundations for growth and stability have been laid. Now it is time for all euro Member States to commit to the agreed reinforcement of the Stability and Growth Pact, and to implement and follow the rules of the ‘six-pack’, ‘two-pack’ and Fiscal Compact. With these conditions for stability being set, we strongly believe that the Euro+ Pact and the Europe 2020 agenda will support all national efforts effectively in order to foster sustainable growth throughout the EU.

In the last few years, much progress has been made. But many legislative proposals have not been finalised or have not been fully implemented.

Unfortunately, some political decision-makers and agenda setters are calling for more and more measures, even though the ones agreed upon have not yet come into effect. We call on all participants to stick to the rules and policies already agreed. *Pacta sunt servanda*—reliability is an important precondition for sustainable growth.

In what follows we will analyse each crisis separately and present measures for tackling it, starting at the level of individual Member States. Then we will analyse possible measures at the European level in relation to each individual crisis and work out the conditions for a stable European economy, a stable financial sector that serves the real economy and a stable European Union that is able to react effectively to adverse shocks.

Four intertwined crises

The financial and banking crisis

The financial crisis started in the United States in 2008. (We could also refer more narrowly to a banking crisis.) Driven by an expansionary lending policy and weakly regulated actors in the financial industry, who used excessive liquidity to gamble with complex products which they did not understand, the housing bubble burst with unforeseen impacts on the real economies of the world. Mostly top-rated, European banks, which were highly involved in gambling with these speculative assets that were directly linked to subprime mortgages in the US, imported the financial crisis to Europe. In doing so, they disclosed the weaknesses of financial regulation in Europe and the systemic risks that large, weakly regulated banks bring to the real economy and to entire states.

In the meantime, another financial crisis had pushed several banks to the edge of bankruptcy in southern Europe. Driven by low interest rates, an extensive growth of credit volume in Europe took place between 2001 and 2005. This excessive liquidity was not represented in the Consumer Price Index but by the increased value of housing in southern Europe and in the

stock market. The former created incentives to invest in the building sector in Mediterranean countries. For example, Spanish banks did not accumulate the incredible quantities of toxic assets linked to the US housing market as other banks in Europe did. But when the bubble burst, Spanish banks had to deal with a massive number of credit defaults in the building sector. These developments were recognised too late by the European Central Bank (ECB), which had set interest rates too low during its early years of existence. Under Jean-Claude Trichet, the ECB started to increase the interest rate by small degrees in order to cool down the potential bubble, but the negative effects of the events in the US then took over in 2008.

The economic and social crisis

The accumulated risks on bank balance sheets due to toxic assets on the one hand, and to credit defaults in the Mediterranean building sector on the other, led to a situation where investors were searching for safe assets and banks would not lend money to each other. This credit crunch hit the real economy hard. Furthermore, aggregate demand decreased substantially. Gross domestic product (GDP) growth rates were negative in most European Member States in 2009 and 2010.

Not all Member States could find their way back to a path of growth. Furthermore, political mismanagement, delayed reforms and necessary but not undertaken reforms had led to a significant loss of competitiveness in several Member States. Each country was struggling with its own situation, but in many cases reforms were necessary, especially with regard to the inefficient and inflated public sectors, social security schemes and labour markets. The urgent need for these reforms was hidden by low interest rates before the crisis, when states could still borrow money to refinance their debts. Another key problem within the euro area arose from the common interest rate of the ECB. Monetary policy was not able to react to individual situations when wages rose, particularly in the southern European countries. This led to a serious loss of competitiveness. Germany successfully reformed its labour market and, thanks to the restraint of German trade unions before

the crisis, Germany was able to regain its competitiveness. The reduction of the real unit labour cost in Germany prevented the increase of overall inflation in the eurozone that would have been caused by the wage increases in southern Europe. The nominal interest rates needed to increase in these countries with inflationary tendencies, but this was not possible under the common currency. A closer look at regional real interest rates before the crisis and now clearly shows unsustainable differences within the euro area. Another important measure of the significant macroeconomic imbalances is the Target-II balances of the euro system, which indicate on the one hand the serious current account deficits, and on the other hand the amount of capital flight from certain states.

For some Member States there will be no alternative to painful internal devaluation in order to regain competitiveness. The relative price level in Greece, Portugal and Spain is too high if these countries want to find their way back to real growth. This reminds us of the need for closer coordination of financial and economic policies under the common currency.

Due to the combination of a lack of competitiveness, the credit crunch, high expenses for the public sector and a lack of reforms in the labour market and social security schemes, the real economy entered a deep and enduring recession in several countries. An immediate consequence of this was high unemployment. Due to lower income from taxation, governments were forced to cut spending, which worsened the situation for many people searching for work. Furthermore, health and education have been affected by the fiscal constraints that governments are now facing. This social dimension cannot and should not be ignored, but it is directly linked to the economic situation.

These economic circumstances have led to lower tax income for these national governments but higher expenditures, thereby aggravating the sovereign debt crisis, as did the bailing out of certain banks.

The sovereign debt crisis

Some Member States have focused too much on either the finance sector (the UK) or seasonal industries like the building sector (Spain), while other Member States have built up far-too-inflated state and social sectors, which were neither flexible nor competitive, leading to a sustainable decline in growth. In combination with the impacts of the financial crisis on many national budgets, the consequences have been devastating in these countries. In addition, France and Germany significantly weakened the Stability and Growth Pact between 2001 and 2005. This opened the door for other Member States to 'smooth' their consumption via excessive deficits in order to relieve the pressure in the short term for necessary reforms, thus delaying them further.

Some European countries, partially due to the necessity of saving the banking sector and partially due to rampant fiscal mismanagement in recent decades, developed excessive national debts. The already timid financial actors—influenced by hardly objective US-based rating agencies—stopped lending to countries like Ireland, Greece, Italy and Spain, and interest rates reached a level that is no longer manageable, since the primary surplus now needs to be even higher to prevent a further increase in the debt burden. To break this vicious circle of indebtedness will be a major challenge. The primary surplus (being government income minus expenditures) needed to hold the debt-to-GDP ratio at least constant depends negatively on the GDP growth rate, but positively on the nominal interest rate for refinancing. If the latter variable is very high and the growth rate very low, as is the case in several countries, the primary surplus has to be consistently high to prevent a further increase of the debt ratio.[3] In the short term, this creates a vicious circle if only the interest rate rises. The consequent cuts in government expenditures in order to increase the primary surplus could have negative short-term effects on the growth rate. But the growth rate then negatively determines the primary surplus, which has to increase even further. Measures already exist at the

[3] This argumentation is simply illustrated by the German Council of Economic Experts (2011) with the formula:

$$p = d\,(i - g),$$

where p is the primary surplus needed to hold the debt-to-GDP ratio (= d) constant, i is the nominal interest rate and g the GDP growth rate. For a detailed and intertemporal analysis see Blanchard (1990).

supranational level to tackle this vicious circle in different dimensions. They will be presented and discussed later in this article.

The political crisis

The social dimension of the crisis has also nurtured a political crisis. In general, in difficult populist and radical parties on both sides of the political spectrum will experience an upswing. This has happened in France, Finland, Greece, Denmark, the Netherlands and other countries. We believe that the political dimension of the crisis should not be underestimated, as it highlights some of the weaknesses regarding the institutional set-up of the European Union, including how the European decision-making process is regarded by the population, even though, in general, support for the European Union is secure. The European Social Model has to be defended, but should also be reformed. Summit diplomacy has made it obvious that apart from developing hopes and ideas that are not realistic, the willingness to act on decisions with a real direct impact is missing. The principle of unanimity in the Council has cancelled out the democratic processes of the Community method. Too many decisions have been communicated as if there are no alternative solutions. Political decisions need to be explained by highlighting the advantages and disadvantages of alternative options and finally summarising their purpose.

Return to sustainable growth

There is no all-purpose method for restoring growth. Concerning the questions of economic growth, Nobel Prize Laureate Robert E. Lucas wrote, 'Once one starts to think about them, it is hard to think about anything else' (1982). Each of the four crises described deserves particular attention, and policymakers must use different methods in order to move the European Union back onto the path of stability and growth. But each policy cannot be analysed independently of the others. An integrated approach is necessary, as they are related to each other and are intertwined. However, we need to differentiate between actions that need to be taken on the Member State level and those that need to be taken on the supranational level.

Member State reforms

The different national economies in Europe will only achieve sustainable growth if they fulfil the preconditions of financially restructuring their national budgets and implementing the necessary structural reforms. But these are not tasks that can be done according to a general scheme. In every Member State, individual circumstances have to be taken into account in doing so. We believe that the suggestions below could help these countries to get back on track.

Spain needs to move the regions' individual autonomy on finances to the central government. This will reduce corruption on a regional level and lead to better financial supervision. Furthermore, in the recapitalisation of the financial sector, Spain should include those private investors who built their wealth on credit in the housing bubble.

Portugal's economy is too strongly based on the agricultural sector. To increase its competitiveness is the major challenge the Portuguese government must work on. Tourism and agriculture are no longer enough.

Italy has promised reforms in the labour market and in public administration for years. These reforms are finally being carried out. Corruption and tax evasion must be fought. It is also necessary to reduce the large differences between the economies of the northern and southern parts of Italy.

Greece has taken the first important steps on the very long path to consolidation and now faces the need for tremendous domestic economic, political and democratic reforms. Whether Greece will remain in the eurozone in the long run will depend on the strict implementation of these reforms. Other Members of the eurozone stand ready for solidarity, but this will require considerable efforts from the Greeks themselves.

Ireland needs to improve its banking sector regulations. Ireland's economy is not capable of providing deposit protection to large multinational banks, which, in part, has led to the excessive increase of sovereign debts.

France should carry through its reforms to the labour market and to the general framework of its economy. It should focus more on the European Internal Market and open up more sectors of its economy to competition. The competitiveness of the French economy is suffering due to high labour costs. Here the French government must find agreements with the powerful labour unions.

Germany needs to follow the path of deleveraging, without thwarting this process by offering more and more social benefits. It should stick to the successful features of the Social Market Economy (Mombaur, Langen and Rauen 2001), and support the consensus between trade unions and employers.

The United Kingdom will need to scale down its financial sector to a feasible size, even though this will lead to some difficult cuts in the labour market.
As far as other Member States go, the newer ones (Poland) and smaller ones have managed rather well and have seen impressive growth rates in the years of convergence before the crisis hit. They need to make sure that their economies are not overheating or experiencing excessive inflation due to the currently cheap costs of refinancing.

European Union and eurozone reforms

Beyond the individual reforms in each Member State, the crisis has highlighted the necessity for reforms on the EU level, in its economic policies, market regulations and also in its institutional set-up. The economic and fiscal policies of Member States can be coordinated at the EU level.

Stability and growth will only be possible in the EU if the Member States can agree on a number of important points.The Commission must find a way back

to defining broad policies instead of entangling itself in process management and small details. This also means that the different parties need to cooperate instead of proposing contradictory policies.

The sovereign debt crisis. Each Member State must begin the process of deleveraging its sovereign debts. This has to be ensured by the effective enforcement of the Fiscal Compact, the Governance Package (the 'six-pack' and the 'two-pack') and the European Semester. With regard to the Macroeconomic Imbalance Procedure, we wish to emphasise that successful economies and their undertakings should not be forced to restrict exports in order to align the differences in current accounts with other non-competitive states. This would only lead to an overall decline in growth in Europe. Instead, we need to create and use mechanisms that allow some Member States to move ahead without creating any separation in the Union. All Member States must always have the opportunity to join the fast-track club as soon as they meet the necessary criteria.

There are different possible measures that can help to smooth the painful adjustment period of reforms and necessary expenditure cuts. Additionally, such measures can help to break the short-term vicious circle between interest rates, expenditure cuts and the growth rate in relation to a sustainable debt ratio.

The ECB stands ready to buy sovereign bonds on the secondary market. This action is highly controversial among economists and policymakers. But since political leaders have not been able to act quickly enough, there seems to be no alternative to this exceptional and interim measure that would reduce the interest rates for governments in the short term, helping to avoid the vicious circle described above. The same result could be achieved by the European Stability Mechanism (ESM). Here, we oppose the idea that the permanent ESM could receive a banking licence combined with the right to buy bonds, even from the primary market, since this could undermine the ECB's objectives and instruments to effectively guarantee price stability in the eurozone. On the other hand, the ESM can give financial assistance to states

that agree in return to implement structural reforms, specific measures for their expenditure and other policies. This would lower the interest rate, which would lead to lower expenditure. The financial assistance provided via the ESM could smooth the initial decline in the growth rate due to expenditure cuts and reforms during the adjustment period until the reforms take effect. Due to the reliable commitment to reforms, a higher growth rate could be expected in the long run.

Another idea for breaking the vicious circle of indebtedness due to high interest rates is the mutualisation of debt. We strongly disagree that this measure would be in any way capable of solving the current debt crisis. By its nature it could theoretically only function as a long-term instrument, and then only if certain criteria are met. In contrast to the assistance of the ECB and the ESM, mutualisation gives states that have failed to get their budgets in order in the past a 'free ride' to decide independently on their financial and economic policies. Until the strict rules of the 'two-pack' and the Fiscal Compact are implemented effectively, the risk of moral hazard remains. Furthermore, it will be politically difficult to convince taxpayers in stable countries to pay higher interest rates when other, more effective measures are more than adequate. In addition, a mutualisation of debt—in any possible way—is against Article 125 of the Treaty on the Functioning of the European Union and therefore not even legally realisable in the short or medium term.

With regard to the European Monetary Union, we support the vision of an integrated budgetary framework that ensures coordinated fiscal policymaking at the European level.

The economic crisis. The European Internal Market must finally be completed. The Commission must push for the full implementation of the rules and regulations that are already agreed upon. The Euro+ Pact to assist euro Member States with regaining competitiveness and the Europe 2020 agenda with its seven flagship initiatives for smart, sustainable and inclusive growth provide an important framework at the supranational level for further investments in long-term growth. The European Semester will facilitate the

coordination of European and national economic policies in order to enhance competitiveness, employment and growth.

The financial crisis. The banking and finance sector needs to be regulated in a comprehensive way. This regulation has to include a mechanism of solidarity that inhibits speculations in order to unleash the full potential of the European economy. We see many possible improvements in order to bring the financial sector back to its core function, which is serving the real economy. In this regard, several legislative procedures are on the way, in particular concerning credit rating agencies, capital requirements for banks that will reduce the systemic risks of banks, a regulation on the clearing and reporting of over-the-counter derivatives, the regulation of financial markets concerning their structure, high-frequency trading, and transparency and consumer protection, as well as the proposals for European banking supervision and a banking resolution. In this regard, it must be clear that we do not support a common deposit guarantee scheme which requires that the depositors pay for mismanagement in other countries. Concerning national deposit guarantee schemes and a bank resolution mechanism, it is highly important to prevent any incentives for banks to 'gamble for resurrection'.

The political crisis. Europe needs a full reform of its structural and agricultural policies. We cannot continue as in the past. New goals need to be set in order to create a real benefit for Europe and to meet the actual needs of the Member States. Our policies in these sectors are too much influenced by agreements that were made long ago. The European decision-making process has to move away from its summit-politics character.

After the accession of Croatia, the European Union must hold the accession process and start to consolidate and integrate. For the time being we should focus on a new Neighbourhood and Partnership Policy. The Union should also renew its Southern Mediterranean policy to meet the new political reality in northern Africa. However accession prospects must be open, especially for the other countries of the Balkan.

In the long run, one should consider the idea of a real European budget that could accommodate adequate reactions at the European level to adverse shocks. EU institutions must be rendered more effective, more visible and fully supportive of the principle of subsidiarity. We should step away from crisis management and return to the open legislative procedures of the Community method. We should also further increase the number of decisions taken via a qualified majority and reduce those taken by unanimity in the Council. In the long term, we need to think of giving new competences to the European level, particularly in the economic and financial fields.

Although we need to think about long-term developments, we do not believe that a discussion about treaty changes and the entire institutional set-up of the EU will help to stimulate growth and solve the crises described, since actions need to be taken now. Nevertheless, it is extremely important to make actions and decisions comprehensible. Agencies and institutions need to be reliable. For this reason the European Parliament demands that institutions and agencies give an account of their actions in front of the elected representatives of the European Union.

Conclusion

We have presented our view on the four different but intertwined crises, and have suggested and commented on different policies for real and sustainable growth in Europe. It is clear that sustainable growth cannot be achieved through budgetary deficits. No fiscal stimulus would be able to relieve the need for structural reforms. Fiscal consolidation is a prerequisite for creating an investment-friendly environment for undertakings. Several Member States of the EU need to work hard on their competitive advantages so that the macroeconomic imbalances will decrease.

Each crisis has its own sources. Spillover effects have worsened the situation. There is no general solution for growth. Hence each problem in each Member State needs to be tackled individually, but in coordination with other measures. Without the efforts of the Member States themselves, Europe will

not find its way back to the path of growth. Despite the risk of aggravating the economic situation in the short term, tough reforms need to be implemented. At the European level, measures exist to smooth this adjustment period and help Member States to return to growth more quickly.

Many actions for growth have already been implemented and important legislation is still on the way—at both European and national levels. It is time now to evaluate these policies and to ensure the strict and effective implementation of agreed-upon measures. Reliability at the European and national levels is the first step towards ensuring that the economy seems secure and ready for long-term investments. Peace, prosperity and stability have been the hallmarks of Europe. It is time for action and for commitment to the agreed-upon policies, in order to get Europe back on its pathway to growth.

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