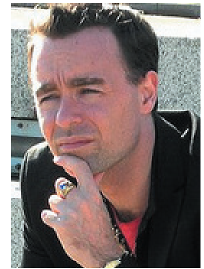
EU Growth Strategies amid Sovereign Debt Crisis



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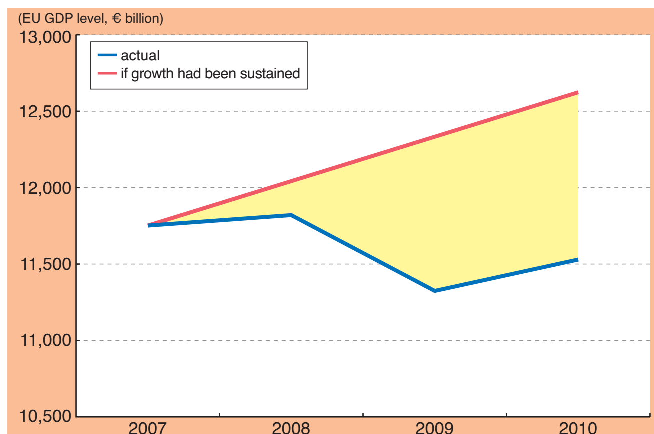
Challenging Times for Europe

Since the onset of the sovereign debt crisis in 2010, these have been extremely challenging times for Europe. Unfortunately in Japan, the euro-zone has become the subject of the wrong kind of attention due to the alarm caused by often overstated threats of economic contagion. This article attempts to explain that, while the fundamental problems facing Europe are serious and complex, they have also been exaggerated and indeed exacerbated by volatile financial markets. I will argue that the euro's media critics are quite mistaken in their frantic predictions of the euro-zone's imminent failure or disintegration. Recently, I witnessed one well-known European journalist warn a Japanese investor audience about the prospects of a European war after a euro-zone collapse that he was predicting to happen "within 10 days." My own less dramatic standpoint serves not as a denial of reality but rather as a frank recognition of the challenges ahead for Europe and how, unfortunately, there are no simplistic "silver bullet" solutions. Despite the current difficulties and prospects of weaker growth in 2012, Europe must not be tempted to trade short-term relief for long-term distress; resolving this crisis will require nothing less than the implementation of historic and sequential reforms. The vibrant democracy of Europe must not be bullied into unwise and ultimately ineffective actions by pressure from financial markets or by a stream of hyperbolic media headlines and deadlines.

In reality, there is little doubt that the euro-zone will emerge stronger after a series of major reforms to build a more robust economic and financial architecture. Historic measures include the creation of the European Financial Stability Facility (EFSF) while the European Stability Mechanism (ESM) will come into existence from mid-2012. The "fiscal compact," a new intergovernmental treaty to reinforce fiscal discipline and governance, has been formulated and builds upon the lessons learned from the past deficiencies of the growth and stability pact. New financial regulations and bank recapitalisation decisions are landmark actions in the financial sector. There are discussions about a Financial Transactions Tax, which as well as potentially being an important new source of revenue, is itself an economically and morally fair levy on the financial sector. The Eurobonds debate is also well underway, not as a short-term panacea but as a core part of a new structure of economic governance in the longer term. The crisis has prompted the development of an increasingly proactive European Central Bank. As a direct result of the crisis, major structural reforms are happening across Europe, at a rapid pace that few optimists could have ever predicted. Yet, for some, building the economic governance frameworks for our future or the launching of a wave of structural reforms to improve our competitiveness and growth are merely labelled as *"kicking the can down the road"* or *"too little, too late"* in the ever-expanding lexicon of sardonic crisis cliché.

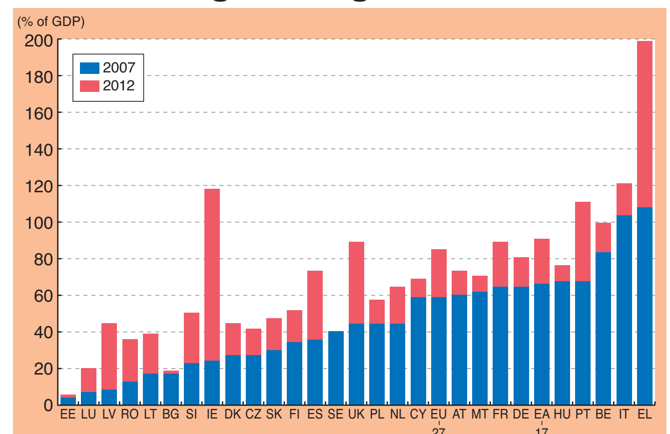
European leaders have repeatedly stressed that austerity measures alone are not sufficient and in early 2012 a "Growth Summit" highlighted the urgent need to restore growth. The Summit outlined the priorities for growth, which included the urgent need to stimulate job creation, to complete the Single Market, and to support SMEs. The challenges facing Europe remain quite daunting but the political will to tackle them is strong, determined and unbending.

CHART 1
Actual growth compared to (crisis-free) growth



Source: European Commission

CHART 2
Fiscal impact of the crisis – general government debt



Source: European Commission

Origins of European Sovereign Debt Crisis

The European sovereign debt crisis is often said to have originated from the economic destruction caused by the global financial crisis (GFC) in 2007 and 2008 *(Chart 1)*. According to the EU Commission, it is estimated that the EU lost about € 2,000 billion in the 2007-2010 period due to the GFC, an amount equivalent to the GDP of France. The second destructive impact is evident in European public debt-to-GDP ratios, which increased by 20 percentage points on average and are expected to reach 85% of GDP in the EU and 90% in the euro area by 2012 *(Chart 2)*. Despite this significant fiscal deterioration, it is important to note that Europe's average public debt levels are still far below the level carried by Japan. Spain, one of the countries under market pressure, has a public debt to GDP ratio of just over 70%, yet this is called a "sovereign debt" crisis. Liquidity and market confidence are the main challenges faced, not the fiscal solvency of Europe or the viability of the euro currency.

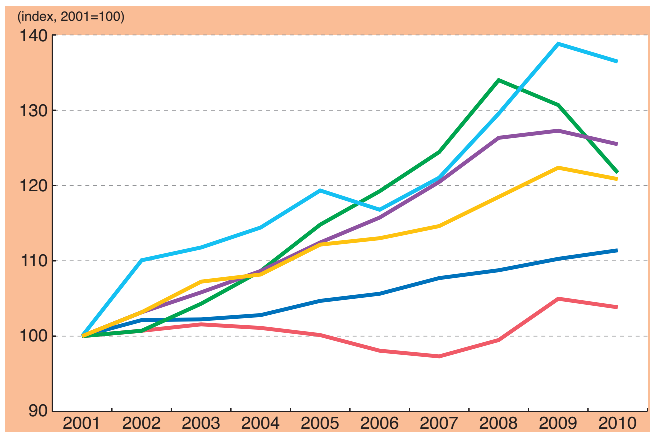
While the GFC thus undeniably inflicted enormous economic damage upon Europe, that crisis could also be viewed like a hospital X-ray that has exposed some serious pre-existing illnesses from the supposedly "healthy" years of growth in Europe. The point being that these pre-existing problems would have inevitably emerged at some stage and the GFC merely brought this day of reckoning forward. For example, the fiscal sustainability problems of Greece, which included systemic failures in tax collection and basic government statistics calculations, were being masked by average GDP growth rates of 4% from 2001 to 2007. Indeed, Greece was widely perceived to be finally catching up with the core EU economies. At the same time, Ireland was building a property bubble that drove consumer spending and boosted government revenues through large property tax revenues. Rising property prices were justified by the "miracle" of the Celtic Tiger economy. However, this Irish growth was being fuelled by speculative lending that would later result in gigantic banking losses.

Contrary to hopes of economic convergence after the euro launch, unfortunately we can see that disparities in competitiveness and productivity were actually widening in this period. *Chart 3* confirms how competitiveness was declining in the last decade due to sharply rising labor costs in Ireland, Greece, Spain and Portugal. Capital inflows were allowed to fuel credit and asset booms while current account deficits were financed by these fragile sources of international funding. This created a dangerous insensitivity to current account imbalances that weakened incentives to maintain industrial competitiveness. These are the structural problems to be corrected today and no "silver bullet" or overnight remedy exists. Instead, it will take the implementation of step-by-step reforms that require time and tenacity. It should be noted that Ireland has already achieved excellent progress since requiring assistance in late 2010 and this is being reflected by declines in the borrowing costs for Irish bonds.

Unfortunately, growth rates before 2007 also helped to mask the birth defects contained within the growth and stability pact. The principals of fiscal discipline were fine but rules without penalties carry little authority. The economic principle of *deficit bias* says that politicians will often take the short-term perspective based on electoral considerations and thus push spending costs onto future generations. In a monetary but not a fiscal union, unconstrained by higher borrowing costs, some Member States became accustomed to a standard of living not matched by their competitiveness or productivity levels. European governments have admitted this failure and are currently showing strong political will to strengthen fiscal discipline through the drafting of a "fiscal compact" to better avoid the build-up of excessive deficits and debt. Central to the new plan is a debt brake that requires corrective measures at a deficit of 0.5% of GDP, and a Member State will face automatic penalties if the deficit exceeds 3% of GDP, which is the same limit as in the original pact. Automatic sanctions and stricter surveillance will lead to enhanced fiscal credibility in the financial markets. An intergovernmental treaty will make this agreement binding and enforceable. It is not a bland overstatement to call this new structure a historic step towards a closer fiscal union that will complement and support the existing monetary union. Maintaining fiscal discipline and closely monitoring competitiveness with clear sanctions to prevent unsustainable economic policies is a huge step towards repairing growth prospects.

CHART 3

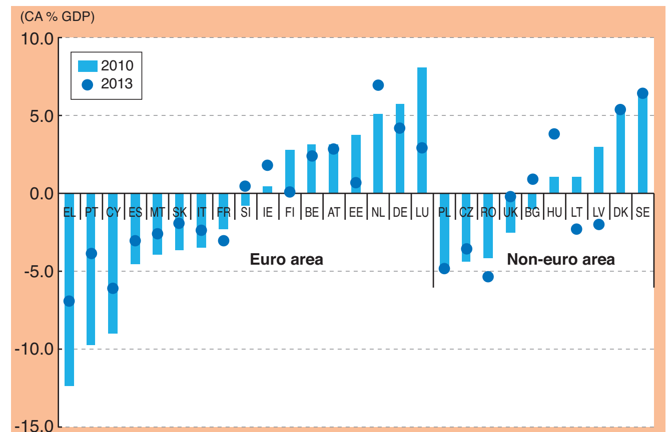
Trends in nominal labor costs



Source: European Commission

CHART 4

Curent account situation



Source: European Commission

Achieving Sustainable Growth through Structural Reforms

Many analysts warn that excessive austerity measures in Europe in 2012 will likely weaken growth and push the euro-zone into a recession. While there must be a valid debate about the optimum speed of deficit reduction, fiscal consolidation is an absolute prerequisite to restore macro financial stability. Smart consolidation is required to limit the damage to key growth drivers such as R&D and education, but we must remember that many of the problems of the current crisis came from wasteful government spending, which must be corrected.

With media coverage of Greece being relentlessly negative, we often miss the excellent progress being made under extremely difficult conditions. One key example is the reduction of the Greek primary deficit by 8 percentage points from 2009 to 2011. Greece has begun the process of implementing structural reforms such as the liberalization of 140 "closed shop" professions such as taxi drivers and pharmacists in a long-overdue effort to reduce barriers to competitiveness and to spur more vibrant economic activity. Privatization is another vital area where Greece has set a target to raise 50 billion euro. As well as providing much-needed revenue, privatization will help to introduce market forces into stagnant sectors of the Greek economy. Another key reform is the modernization of the tax system, which clearly has not been working, as evidenced by high tax evasion rates. This reform is not merely to assist in the resolution of the current crisis; the future economic sustainability of Greece is simply not possible with a dysfunctional tax system. After the expansion of the public sector in recent years, a major correction is required, and the government plans the merger and closure of 150 public-sector entities as well as a reduction of 150,000 public-sector jobs by 2014. Pension system reforms are always unpopular with the electorate but retirement ages will be raised and benefits lowered. In summary, Greece is correcting years of economic mismanagement, there are no easy alternatives, and there will be obstacles ahead in achieving these reforms.

Given the inevitability of fiscal consolidation, structural reforms, as well as correcting obvious imbalances, will enhance the efficiency of the EU economy as a whole. While structural reforms deliver results gradually over time, creating a road-map to competitiveness will also have a positive short-term effect by improving investor confidence, thus helping those currently under market pressure. One of the key lessons of the crisis is the importance of economic and investor sentiment and how easy it can be to become trapped in a negative feedback loop. In theory, there should be little trade-off between fiscal austerity and growth; while taxes rise and public spending cuts may hurt economic activity in the short term, markets should respond positively to lower deficits by lowering borrowing costs, thus stimulating the economy. It is certainly hoped that this will be the case for Italy, which has made indisputable progress by implementing budget cuts of €80 billion through 2013 as well as making credible pledges of structural reforms. This is particularly important in the context of Italy having the slowest growth rates of all euro-zone members since the euro was launched.

European Priorities for Growth & Job Creation

At a European leaders' summit in late January titled the "Growth Summit," three key growth-creating priorities were identified for immediate consideration by Member States. They are: 1. *Stimulating employment, especially for youth:* With more than 23 million unemployed in Europe today, there is the urgent need to improve growth and boost job creation. Each Member State will set out concrete measures to address the unemployment issue. EU Funds will be provided to help provide better youth training and work experience programs as well as facilitating improved skills-matching in the market. In some Member States, the unemployment rate is over 20% and youth jobless rates are even higher, so this is an urgent social priority. 2. *Completing the Single Market:* The Summit stressed the necessity to continue to reduce the regulatory burden on small and medium-size enterprises (SMEs). Europe must speed up growth-enhancing policies including the implementation of existing commitments on services, energy and the pursuit of free trade agreements. Emerging markets are still expanding at a significant pace and this can provide many new opportunities to European exporters and investors. 3. *Boosting the financing of* SMEs, which are the backbone of Europe's economic success and a big provider of employment. It is crucial to take measures to avoid the present credit crunch limiting SMEs' ability to grow and create jobs. The December 2011 measures taken by the ECB in providing cheap liquidity to banks have been positive in that respect. However, national supervisors must ensure that bank recapitalisation does not lead to excessive deleveraging with the potentially damaging effects on SMEs.

Conclusions

The economic outlook for Europe remains subject to uncertainty and downside risks in 2012. Demand will likely be weakened by ongoing sovereign debt concerns as well as by balance sheet adjustments in the financial and non-financial sectors. A focus on austerity measures alone will not solve the debt crisis; fiscal discipline must be intelligently interwoven with ambitious structural reforms to ignite dynamism, productivity and competitiveness. It is true that structural reforms take time and we have seen market impatience push solvent sovereigns towards a liquidity crisis. However, there are no silver bullet solutions, and what Europe needs most is to restore market credibility and lower borrowing costs. The EU has also put forward many ideas to stimulate growth in the short term because we cannot accept that almost a quarter of Europe's young people are facing unemployment. Countries at the start of a tough road to recovery can look to the painful structural reforms taken by Germany from 2003 to 2005. The fruits are visible today in German unemployment at 20-year lows and in the country's strong competitiveness and productivity. With strong political will, the EU is pushing forward to restore confidence and growth. In the not too distant future, we may even grudgingly acknowledge that the painful challenges posed by the sovereign debt crisis have in fact jolted the EU back onto the right path to a more sustainable economic and political future. JS

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