FRIEDRICH EBERT STIFTUNG

INTERNATIONAL POLICY ANALYSIS

Europe at the Crossroads

Ways Out of the Crisis

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May 2011

- The neoliberal construction of the Maastricht Treaty – a monetary union without a political union – has brought the Euro area to the brink of collapse.

- Anti-crisis policy is characterised by three errors. It attributes skyrocketing national debts to an allegedly lax spending policy; finds wage policy responsible for current account imbalances in deficit countries; and allows those really responsible for the massive national debts – the banks and insurance companies – to dictate the financing and economic policy discipline of debt-ridden states.

- In order to be able to re-stabilise the European integration process a fourfold paradigm change is necessary. Europe needs: a new growth strategy, democratically-controlled economic government, Europe-wide coordination of wage, social and tax policy and European rules on debt financing.

Content

1. Introduction: The Aberration of Maastricht

The European Union (EU) finds itself in its biggest crisis since its foundation. The origin of this crisis lies in the construction of the Economic and Monetary Union (EMU). The architects of the Maastricht Economic and Social Treaty believed that they could handle EMU without political union. They did not accompany monetary policy integration with economic policy integration. There is a single currency but no European Social Constitution. There was broad political support for this asymmetric path to monetary union, although for a variety of reasons. Some advocates took the view that the introduction of the euro constituted a first step towards a deepening of the Union's economic and social integration, which would be followed by so-called *spillover* processes.[1] This position was strongly represented among Europe's social democratic and socialist parties and in the European trade union movement. Another group among the supporters of the Maastricht Treaty represented the neoliberal position that the path taken was the right way to pursue a monetary economic policy in the EU, since in any case fiscal policy is outdated. The neoliberals hoped that the Maastricht system would put national wage, social and tax policies in competition with one another. By means of such a system of market states public spending ratios could be reduced across Europe and workers and their trade unions could be weakened. Critics of Maastricht called into the question the alleged spillover processes and pointed out that a common currency which was not embedded in a real political, economic and social union would fail. The course of European integration since the early 1990s and the current deep crisis of the Eurozone show that the Maastricht project was a false path, which today endangers the entire integration process.

However, instead of learning from these mistakes and making good the construction errors of the Euro-architects the dominant political forces in the EU are exacerbating the crisis with a stronger dose of the wrong medicine. The European Commission and many European governments, led by Germany and France, believe that a tough austerity programme and wage cuts will be able to overcome the crisis in deficit countries. But in this way the economic problems of the EU will not be solved and social conflicts will not be alleviated.

1. If integration steps compel further integration steps on functional grounds – for example, a monetary union necessitates an economic union – one talks of *spillover* processes.

2. Policy Responses to the Euro Crisis

The crisis of the euro, which has been worsening since spring 2009, has three dimensions:

- public debt has increased dramatically as a result of the economic and financial crisis;
- the current account balances of the euro countries are continuing to diverge;
- public finances are still in thrall to unregulated capital markets.

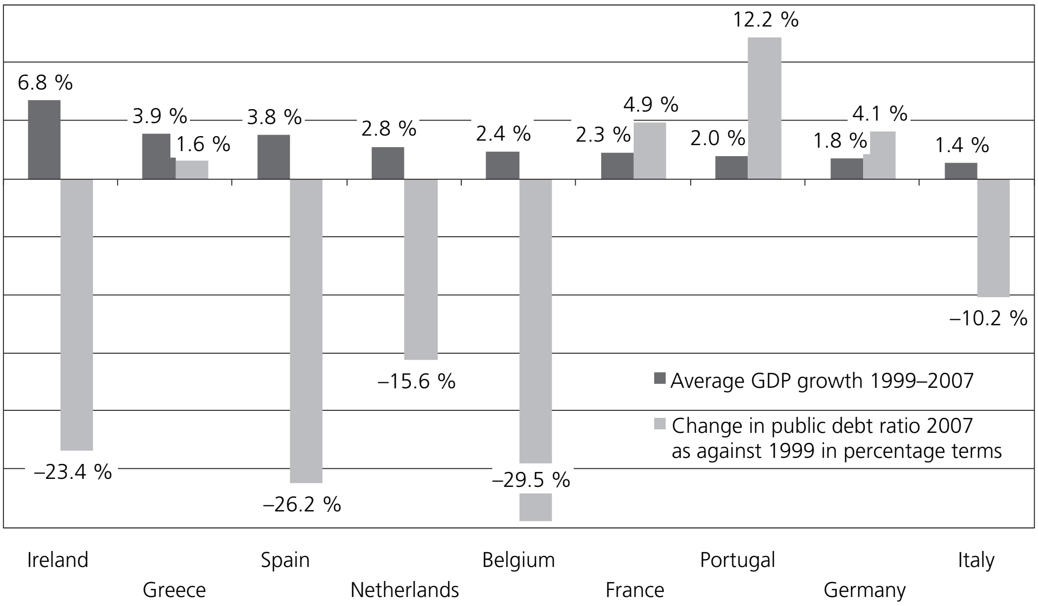
In the first two crisis dimensions the official policy responses are a quid pro quo. The debt crisis is explained by the political and economic mainstream in terms of allegedly lax public spending. Prevailing political opinion attributes the current account deficits of some member states to excessive wage increases, which are supposed to have undermined the competitiveness of the states which are now in crisis. In fact, the increase in public debt has its roots – as Figure 1 and Table 1 show – primarily in the global economic and financial crisis, which forced governments to implement anti-cyclical economic stimulus and rescue programmes for the banking sector. Table 2 shows that it is primarily restrictive wage development in Germany that is responsible for the price-related distortions of competition in the Eurozone.[2] As a result, current account surpluses have arisen in Germany and in many neighbouring European countries high current account deficits. Finally, official policy has permitted the banks and insurance companies, whose delinquent behaviour caused public debt to explode (see Table 1), to determine market conditions for the debt financing of state budgets and to dictate the economic policy course of highly indebted countries.

2.1 Reasons for the Increase in Public Debt

The prevailing policy has managed to impose its interpretation of the crisis. Inverting cause and effect gov-

2. The adverse wage development is not the result of wage moderation, but rather the expression of policy-induced labour market difficulties. The deregulation of temporary agency work, Hartz IV, extended permissible time limits and one-euro jobs, as well as tax concessions to promote mini- and midi-jobs have markedly weakened the trade unions' negotiating power. The decline in binding collective agreements did the rest. What trade unions negotiate today no longer covers all employees. Consequently, general wage development remains behind wage settlements.

Figure 1: Growth and debt ratio



Source: Statistisches Bundesamt.

ernment debts now appear to be the root of all evil. The debt mountain is to be reduced by means of tough consolidation programmes. The policy of the European Commission is along the same lines: Brussels, with the support of Berlin, recently proposed to toughen up the Stability and Growth Pact and to equip it with automatic sanctions. Even if this plan has failed in its original form because in a federation of states nation-states are not prepared to let their budgetary sovereignty be undermined by automatic sanction mechanisms, the Stability Pact will be stiffened by means of shorter deadlines and the principle of the reverse majority rule.

The Stability Pact has failed in the past because its economic logic is faulty. It is not by chance that budgetary policy poster-children Spain and Ireland became the biggest problem cases after the crisis (see Figure 1 and Table 1) because private debts elude the Stability Pact's radar. Public finances are closely tied to the economic cycle. The strictest budgetary discipline is all for nothing if the economy is not growing. As a result, a more stringent Stability Pact will again turn out to be a mistake. From the history of national debts we learn that states can only grow out of their debts. Conversely, pro-cyclical austerity measures implemented by heavily indebted states, such

Table 1: Crisis and public debt

	Budget deficit (in % of GDP)	**Debt ratio (in % of GDP)**	
	2010	**2007**	**2010**
Greece	–9.5	99.2	140.2
Ireland	–32.3	25.0	84.1
Spain	–9.3	36.1	97.4
Portugal	–7.3	62.7	82.8
Italy	–5.0	112	118.9
Belgium	–4.8	84.2	98.5
France	–7.7	63.8	83
Germany	–3.7	64.9	75.7
Eurozone	–6.3	65.9	84.1
UK	–10.5	44.5	77.8
USA	–11.1	62.1	92.7
Japan	–9.6	187.7	225.9

Source: European Commission and IMF.

as Greece, Portugal and Ireland, only strengthen the economic crisis, generating a vicious circle. This policy of cutbacks regardless of the state of the economy is wrecking the welfare state and demanding major sacrifices on the part of dependent employees. In all European states which have stepped up their austerity measures social spending – especially pensions – is being cut and public employees are being laid off or seeing their wages and salaries cut drastically.

In this way, the prevailing policy has been able to put the main burden in paying down public debt on dependent employees. In contrast, the real perpetrators of the crisis – the upper income and wealth strata and the financial sector – have largely been relieved of any obligation to play a part in rehabilitating the public finances.

2.2 Divergence of Current Account Balances

Turning to the problem of current account imbalances, the European Commission is proposing a procedure to combat macroeconomic imbalances (excessive imbalances procedure). Balances are supposed to be analysed on the basis of macroeconomic indicators (scoreboard). States are to be compelled to take adjustment measures on penalty of sanctions. One important indicator in this respect is the establishment of the real effective exchange rate[3] on the basis of nominal unit wage costs.[4] States which have lost competitiveness as a result of the development of their unit wage costs should pursue a more moderate wage policy. Here too the quid pro quo means that Germany, as a major surplus country, should not »let its wages get out of hand«. Rather the deficit countries should copy Germany's meagre wage development. The fact is, however, that even in the deficit countries wages have not risen by more than the difference between inflation and productivity increases. On the contrary, because of the weakness of the trade unions, since the early 1990s it has not been possible even to keep real unit wage costs constant in any EU state, with the exception of Denmark, the Czech Republic and Lithuania.[5] With the exception of these three states real wages everywhere have grown more slowly than productivity. Wage policy has not been able to halt the redistribution of income in favour of profits. Across Europe there has been redistribution from the bottom upwards. This also applies to deficit countries in which, according to the official interpretation, wage policy has been overindulgent.

If these states were forced to take the German path:

- The unequal distribution of incomes in Europe would deteriorate further;

- deflationary policy would receive a further boost in Europe;

- the downward spiral of unit wage costs would accelerate.

Germany, too, will try to continue to compete in this »game«. We also consider the demand for symmetrical adjustment – expansionary wage policy in surplus countries combined with wage moderation in deficit countries – to be the wrong answer to the causes of the imbalances. In our view, Germany should first reorient its wage policy because it has accumulated competitive advantages over a number of years.

The competitiveness pact that the German government would like to force on the other EU states in return for the establishment of a European Stabilisation Mechanism (ESM) envisages more radical intervention in the wage policy of member states. On the basis of this pact Belgium and Portugal would have to relinquish their policy of adjusting wages to inflation. Furthermore, all EU states would have to introduce pension reforms on the German model. Acting in the manner of a hegemonic power the German government wants to compel the other member states to adopt its economic philosophy.

3. The effective exchange rate is the trade-weighted exchange rate in relation to the most important trading partners, for example, 35 countries.

4. Nominal unit wage costs measure the nominal, not the price-adjusted, gross wages of dependent employees in relation to the price-adjusted value-added per each employee (labour productivity). This indicator can increase if the trade unions are able to include compensation for inflation in collective bargaining in order to safeguard real wages.

5. With regard to real unit wage costs numerators and denominators are price-adjusted. These remain constant if real wages grow as strongly as productivity.

Table 2: Development of unit wage costs (2000 = 100) and current account balances in percentage of GDP

Development of unit wage costs up to 2008		
Countries	**Nominal unit wage costs**	**Export weighted nominal unit wage costs**
Germany	103	98
France	119	114
Greece	129	117
Italy	126	123
Portugal	123	114
Spain	127	119
Eurozone	119	124

Current account balances in percentage of GDP		
Countries	**2000**	**2007**
Germany	–0.5	7.5
France	1.9	–1.0
Greece	–7.2	–14.1
Italy	–0.1	–2.4
Portugal	–9.9	–9.5
Spain	–3.9	–10.2

Source: Eurostat.

2.3 Capital Markets Still Unregulated

The recent liquidity crises in Greece and Ireland were able to intensify only because of inadequate regulation of the capital markets. As a result, political leaders are still desperately soliciting the confidence of the markets. It resembles a play staged in a madhouse: the banks and insurance companies which were rescued with taxpayers' money are setting the price at which states can borrow fresh capital, while rating agencies which before the crisis issued the highest ratings to worthless paper, now pass judgement on the creditworthiness of Madrid, Dublin and Athens, and hedge funds and investment banks can bet on the insolvency of individual states with credit default swaps. As a result, risks premiums are rising. Financial investors who all too recently sank savings deposits in the ghost towns of the Costa del Sol are now supposed fit to discipline European treasurers. The governments of the EU member states which only recently wanted to regulate every financial institution and every financial product stand idly by as the scene plays out.

3. We Need a Fourfold Paradigm Change

A radical policy change is needed to make it possible to stabilise the European integration process both economically and socially. This would involve a fourfold paradigm change in the following areas:

- growth strategy;
- the EU's fiscal policy architecture;
- the formation of European wage, social and tax policy;
- the construction of European rules on the financing of public debt.

3.1 Strategy for Qualitative growth and Employment

Most urgent is a new European strategy for qualitative growth and employment which takes into account that public debt can be reduced only by means of growth, not austerity measures. This strategy should comprise the following three elements:

- A European New Deal to improve European infrastructure and the environment (transport system, telecommunications, environmental protection): financing could be organised through European bonds. This programme should serve to reduce the development disparities in the EU and to combat unemployment – especially youth unemployment – in countries hit particularly hard by the crisis (Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Portugal and Spain).

- A strong stimulus to domestic demand in surplus countries, with Germany playing a key role. The largest surplus country can help to reduce the crisis countries' deficits by changing its economic policy strategy. At the same time, Germany can contribute to economic stimulus in the EU. This requires a more expansionary wage policy, a reduction of labour market imbalances (minimum wages, equal wages for equal work in temporary agency jobs) and a boost for public investment in education, health care and the environment.

- An end to deflationary austerity policy in above-average indebted countries, whose debt financing should in future be accomplished via Eurobonds. The EU must also signal that it will guarantee the debts of all member states. A general European debt reduction programme should lay down how the member states are to consolidate their budgets in the medium and long term as part of the new European growth strategy and cut their national debts. These measures would eliminate the pressure being put on deficit countries by the international financial markets. In this way their debt servicing could be reduced.

3.2 European Economic Government

The second paradigm change must take place in the EU's economic policy architecture. A European Economic Government must be set up alongside the European Central Bank (ECB). Only when the EU also has a fiscal government can it:

- combat crises effectively;

- implement a flexible economic policy mix[6] which is necessary due to unequal economic development across Europe;

- avoid diverging national debts in the EU and also conduct joint debt management.

The introduction of this institutional symmetry between monetary and fiscal policy, however, would require further democratisation of European institutions. Today, the European Parliament falls far short of what the achievements of the French Revolution might lead one to hope for in terms of its democratic legitimacy and competencies. Only if a European Parliament elected in accordance with the principle of democracy can form a European government should competence for fiscal policy – which also implies the right to intervene in national budgets – be transferred to the EU.

The current integration crisis should be seized upon as an opportunity to take further steps towards the realisation of political union in Europe. But even in the short term, the economic policy of EU states should be coordinated more closely. The European strategy for qualitative growth and employment, described above, cannot be realised without strengthening the EU's economic policy competences.

3.3 Coordination of Wage, Tax and Social Policy

The third paradigm change must occur in member states' wage policy. This should be coordinated at European level in such a way that wage increases in the member states, on average, should use up the distribution-neutral margin (inflation plus productivity increases). This would avoid distortions of competition due to wage costs and help to balance current accounts. During the infancy of this coordination mechanism Germany should correct the errors of the past by means of a strongly expansionary wage policy. Adjustment pressure at the beginning of this paradigm change would be on the surplus countries, not the deficit countries.

If social and tax dumping are to be avoided, stronger coordination of social and tax policy will also be necessary. Corporation tax rates must be harmonised on the basis of a common consolidated tax base. Welfare state policies should be coordinated at European level to the extent that spending on social security systems should be related to member state economic performance. In this way, economic and social progress would go hand in hand in Europe. The strong intervention in pension systems which at present is linked to consolidation policy in many EU states means that a European coordination mechanism is urgently needed for social security systems.

3.4 European Rules on the Financing of Public Debts

The fourth paradigm change must take place in the financial markets: these markets must no longer be able to hold states hostage. In the short term, the European Financial Stability Facility (EFSF) must be improved. Emergency loans should be subject to more favourable conditions. Also, the rescue scheme should be arranged in such a way that rescue of euro heavyweights Italy and Spain is also possible. The euro countries should therefore mutually guarantee their government bonds. The risk premiums and consequently also the interest burden on debtor nations would diminish. Such a guarantee

6. The *policy mix* we have in mind would be a combination of monetary and fiscal policy, one of which can be expansive, the other restrictive.

would have immediate effects and bridge the period until the introduction of Eurobonds.

Eurobonds combine the government debts of euro countries in a common pool of public debt. They should be issued both for existing public debts and for new borrowing and could significantly reduce the financing costs of debtor states. In addition, speculation against states should be constrained by a ban on trading in credit default swaps.

The most radical step to rescue the euro would be direct state financing through the Central Bank, which should be inflation-neutral. In this way, state financing could largely be uncoupled from the capital markets. This is common practice in the USA, Japan and the UK. It is only on the old continent that the ECB statutes forbid this form of state financing. A debate must be held on whether this unique monetary policy characteristic of the Euro area makes sense.

4. Outlook: Change of Direction to Overcome the Legitimation Crisis

The EU is confronted by a dilemma. On the one hand, further integration is necessary in the direction of economic and political union in order to overcome the crisis, but on the other hand, there is no political consensus on this at present. The EU is experiencing a growing legitimation crisis. The causes of the crisis were steps to deepen and extend the Union which were not accompanied by social measures. The increasing hostility to Europe to the right of the political spectrum which can be observed in many European countries clearly illustrates this. The deflationary policies which the EU has been imposing especially on the deficit countries since last year are leading to increasing unemployment, wage cuts and cuts in social services. The prevailing policy is thereby also promoting Euroscepticism in the European labour movement, which was always one of the strongest pillars of the European integration process. The trade unions are alarmed by the development of wage and social dumping in Europe, as well as by the rulings of the European Court of Justice (ECJ) in the *Laval*, *Viking*, *Rüffert* and *Luxembourg* cases, which gave precedence to market freedoms ahead of basic social rights. Today, the trade unions are struggling in many European states against anti-social austerity policies sometimes imposed on governments from outside. Without a radical change of course the danger is that Euroscepticism in many parts of the European trade union movement will turn into open rejection of the European integration process.

Further Reading

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Imprint

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International Policy Analysis
Hiroshimastraße 28 | 10785 Berlin | Germany

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This publication is printed on paper from sustainable forestry.

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ISBN 978-3-86872-714-2