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Stability has a price

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The European sovereign debt crisis is slowly turning into a euro crisis. Germany has a special responsibility for the resolution of this issue. As an exporting nation it is heavily dependent on stable economic conditions in Europe, and for this reason the long-term stabilization of the euro is in a very fundamental way in its interests, even if this means making transfer payments in order to prevent the disintegration of the eurozone.

I

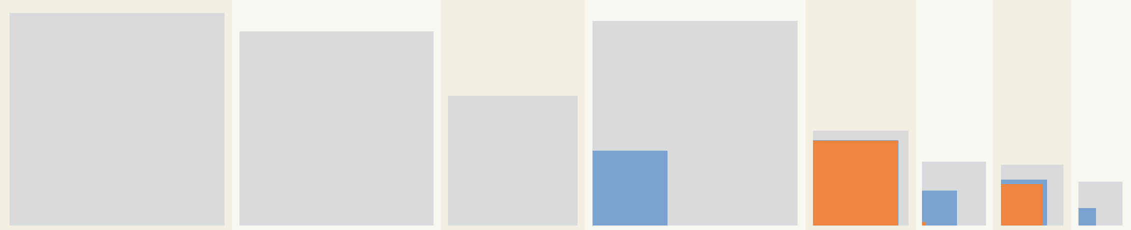
A real euro crisis?

The eurozone is having to face up to the most serious test in its history. The rapidly rising level of public debt in certain member states is taking these countries to the verge of bankruptcy. For a long time the debt issue did not have a significant influence on the euro exchange rate. However, since 2011 the value of the euro has been going down. From May to September 2011 a euro was worth about US$1.46, but by the middle of January 2012 it had dropped to US$1.26.

At first sight a weak euro would seem to be a good thing for Germany as an exporting nation since it means that in other countries the price of German goods will go down. This will lead to an increase in the level of exports and in domestic job security. However, a permanent devaluation of the euro also has its disadvantages as far as Germany is concerned. If international investors believe that the euro will be devalued even further, it will make them think twice about lending money to European states. This can be illustrated with the following example. If an investor from a non-euro country changes 10,000 Swiss francs into euros in order to buy a one-year European government bond, he will incur a loss of 1,000 Swiss francs if the euro is devalued by 10 percent. In order to make up for this he will insist on higher interest rates. However, higher interest rates will make it virtually impossible for the heavily indebted eurozone countries to pay the interest due on their loans, so that seems increasingly likely that these states will become insolvent. And higher interest rates also pose a great problem for the German government. Currently Germany's sovereign debt amounts to slightly more than €2,000 billion. It is true that at the moment the interest rates paid by the German government are extremely low and to a certain extent actually negative. However, if fears about the devaluation of the euro were to push up interest rates by only one percent, it would mean an increase in interest payments of about €20 billion annually. Instability obviously makes everything more expensive. It is thus in a very fundamental way in Germany's interests to bring the European debt crisis and the associated euro crisis to an end as swiftly as possible.

Necessary Write-downs

Assumed write-downs in the case of long-term nominal GDP growth



	DE	FR	ES	IT	GR	IE	PT	HU
Sovereign debt iin billions of € 2011	2.090	1.689	706	1.883	347	162	190	78
in % of GDP 2011	81,8	85,2	66,0	119,6	159,1	104,9	110,1	82,6
Debt write-down in % at 2% growth per annum	0	0	0	13,4	83,8	30,1	55,6	14,8
Debt write-down in % at 4% growth per annum	0	0	0	0	81,9	0,3	45,8	0

Source: European Commission; Bencek and Klodt 2012

II

Not an ideal state of affairs

The main reason for the high level of indebtedness of south European states is their lack of competitiveness. Before the introduction of the euro these countries were able to make up for technological disadvantages in the area of manufacturing with the help of flexible exchange rates. A country which had productivity problems simply devalued its currency, thereby overcoming some of the disadvantages of lower international competitiveness. The introduction of the euro meant that this option was no longer available. The renunciation of a currency of one's own in conjunction with a lack of international competitiveness leads to a decline in a country's exports, a rise in its imports, and a current account deficit. This mirrors a decline in the demand for a country's products both at home and abroad, and this in turn leads to a decline in manufacturing and employment. The lower level of economic activity leads to a decrease in government revenues, and at the same time the financial support given to the unemployed leads to increased expenditure. Both of these things lead inexorably to an increase in government debt.

Against the backdrop of these interdependent relationships, research carried out in the 1960s within the framework of the "theory of the optimum currency area" defined the conditions under which a number of different countries could form a monetary union. Membership of a monetary union is least problematical if the participating economies all have similar productivity levels and identical productivity growth rates. In this case it is not necessary to have a flexible exchange rate in order to bolster international competitiveness. As soon as a member of a monetary union lags behind with regard to productivity growth, it will be necessary to reduce manufacturing costs in ways that are not associated with technological progress. Here the main issue is of how one goes about reducing the prices for factors such as labour, land and capital that play a part in the manufacturing process. Since the international capital markets are gradually developing into networks, it is very difficult for a single country to influence the level of interest rates. Furthermore, countries in a monetary union no longer have their own central banks, which means that national monetary policy is no longer available as an instrument with which one can influence interest rates. Thus a decrease in wages is of crucial importance when it comes to reducing production costs and regaining international competitiveness. If it proves impossible to implement lower wage levels as a result of societal constraints, a country with below-average productivity growth can prevent an increase in unemployment only if its workers are mobile and willing to move to countries in which there are more jobs. As a result of the mobility of labour unemployment does not actually increase in an economy with low productivity. And this means that there is no increase in government spending designed to reduce the impact of unemployment.

However, such prerequisites for a functioning monetary union do not exist in the eurozone. The mobility of labour within the euro area is very limited, and wage reductions are few and far between. But this is not particularly surprising, for even within Germany itself these mechanisms do not function very well. Twenty years after reunification unemployment in the new federal states is still higher than in the old federal states (Federal Employment Agency 2012, p. 48). Economic differences – measured by things such as unit labour costs, economic growth and unemployment – also exist in the US, though migration, price flexibility, vertical financial transfers and factors such as language, culture and common institutions play a far greater role than in the eurozone (see Diekmann, Menzel and Thomae 2012).

III

The need for compromises

So how can the level of sovereign debt in Europe be reduced? First of all the European states must quickly come up with a credible strategy for the consolidation of their public budgets. National and international comparisons show that successful consolidation processes are based on spending cuts and on a stabilization of or an increase in government revenues.

The unavoidable cuts in government expenditure are a kind of balancing act. The spending cuts must be large enough in order to make a genuine contribution to debt reduction. But they must not be excessive, since a reduction in government spending can also have unwanted side-effects. Lower government spending can have a negative effect on urgently needed investments in our future, especially in the areas of education, health and environmental protection. Moreover, a reduction in government spending is bound to weaken demand in general, and will thus have negative consequences for production and employment. This contradicts the whole point of what budgetary consolidation is trying to achieve. The decrease in government revenues, which is a result of the decline in economic activity, and the increase in government spending, which is necessitated by increased unemployment, lead to a situation where government indebtedness goes up instead of down.

However, a reduction in government spending does not necessarily have to lead to a decline in economic growth. If a country's public debt continues to rise inexorably, its citizens will no doubt assume that sooner or later the government will have to increase the level of taxation in order to deal with the problem of indebtedness. This could lead to a rise in the savings rate and capital flight. Both would reduce the level of employment on account of a drop in consumer demand and a decline in investment activity. Budgetary consolidation makes such precautionary measures superfluous. Rising consumer demand would give companies an incentive to raise their investment levels. And increased consumer demand and investment activity would lead to more employment opportunities. These theoretical considerations are called "non-Keynesian effects" and have been substantiated by a series of empirical studies (see Petersen 2006 for a more detailed discussion of this issue).

This is why budgetary consolidation and job protection measures do not necessarily contradict each other. Thus in the light of current European indebtedness and uncertainty about future fiscal policy it cannot be ruled out that a moderate reduction in government spending and a concurrent stabilization of government revenues will actually generate the trust which is required to create positive expectations and a positive atmosphere as a basis for economic growth.

Although there is obviously a pressing need to consolidate public budgets, it is important to bear in mind the actual economic imbalances within the eurozone. Of vital importance for the enduring stability of government finances is a high level of employment. As long as certain members of the eurozone are not competitive in international terms – and currently this applies primarily to Greece, Portugal and Spain – they will be burdened with a high level of unemployment, and this will have a negative impact on public finances.

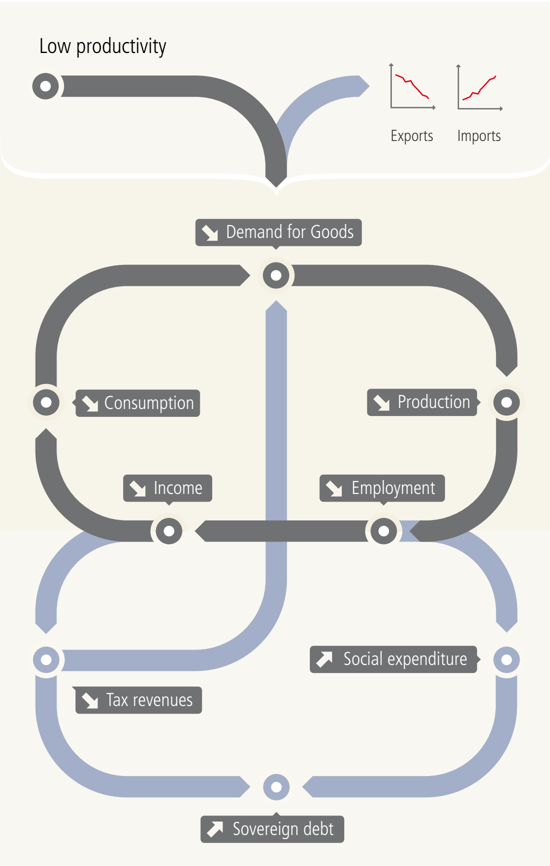
Two important points emerge with regard to the concurrent and much-needed consolidation of public budgets. On the one hand spending cuts should not be made in policy areas which are absolutely necessary when it comes to enhancing competitiveness. This is especially true of expenditure on education. In this area spending cuts can lead to considerable follow-up costs for the government, and they are counter-productive if one is trying to work towards the long-term stability of public finances. Second, the stabilization of government revenues should include an attempt to make the labour factor less expensive. In pay-as-you-earn social security systems the main financial burden tends to be placed on the labour factor, and this leads to high non-wage labour costs. Thus an employment-friendly approach to financing social security systems should focus to a far greater extent on production factors such as capital, the environment and natural resources, which should all be subject to higher taxation.

However, when it comes to enhancing the forces capable of generating growth, one must bear in mind that there are a number of economic and ecological constraints. The global population is currently estimated to be about seven billion and over the next 40 years may well increase to more than nine billion. The impact of a growing population on the climate change issue and the problem of obtaining access to natural resources will create a situation in which somewhere along the line the global economy will be confronted with insurmountable obstacles. This is why sustainable growth is characterized by environmentally-friendly and resource-efficient methods of production. The kind of structural transformation that is needed in order to embark on a path leading to sustainable growth can only be implemented if there are financial incentives. In this area one should primarily think in terms of higher taxes on activities which have an impact on the environment and utilize natural resources, i.e. by imposing an additional tax on CO_2 emissions. Such revenues would at the same time make a contribution to the consolidation of public budgets.

When all is said and done greater economic growth can make a contribution to debt reduction because it leads to an increase in government revenues and to lower levels of spending on measures designed to combat unemployment. But at the same time it is obvious that in some eurozone countries the level of indebtedness has now reached a point where annual nominal economic growth of four percent is not enough in order to deal with the problem of public debt. In January 2012 the Kiel Institute for the World Economy published estimates suggesting that even if such optimistic assumptions about growth are correct, a debt write-down of slightly more than 80 percent in Greece and of about 45 percent in Portugal is unavoidable. "Ireland, Italy and Hungary will be able to avoid a partial debt write-down only

The vicious circle of low competitiveness

Economic consequences for a member of a monetary union with productivity problems



Source: own design

if they attain high macroeconomic growth rates. The prospects for this are fairly good in Ireland" (Bencek and Klodt 2012).

In realistic terms it is difficult to do anything about the fact that there will continue to be considerable differences in productivity within the eurozone even if one were to intensify the measures designed to enhance the level of competitiveness. It is currently impossible to assume that the adaptation mechanisms which are needed if a monetary union is to function properly (a high level of labour mobility and wage reductions) will come into effect in the eurozone in the foreseeable future. If these mechanisms do not come into play, a monetary union can only survive in the long run if the strong economies are willing to make transfer payments to the weak economies. This is the case in Germany within the framework of fiscal equalization among the federal states, and in the US, where about 30 percent of the expenditure of the states is paid for by the federal government (see Becker 2011, p. 45). The precondition for this is greater economic policy integration, and this will make use of instruments such as tax equalization payments and fiscal redistribution in the framework of common social security systems. The associated fiscal transfers constitute a replacement for the lack of labour mobility and the absence of factor price flexibility.

Joint liability of all eurozone states for public debt is another way of making transfer payments. It might be possible to introduce eurobonds or to conclude a debt reduction pact, which is what the "German Council of Economic Experts" suggests in its annual report for 2011/12. Joint liability for debts of the eurozone states would certainly be advantageous, since risk surcharges would turn out to be less expensive. It would enable states which currently have low credit ratings and are faced with having to pay high interest rates to significantly reduce their interest payments. At the same time joint liability would reduce the danger of insolvency in the case of individual states. Speculations about a forthcoming sovereign default would die down, and this would probably lead to a stabilization of the bond markets and of the euro.

IV

Support is better than failure

All of the eurozone countries must do what they can to resolve the European debt crisis. Initially a credible consolidation strategy can be implemented only by each country acting on its own. The same is true when it comes to enhancing international competitiveness. However, the highly indebted economies are coming up against the limits of what is possible and feasible. Without assistance from the economically more powerful nations they will be unable to deal with their very real economic problems and the public debt issue.

Hitherto the German government has fought shy of cost-intensive measures and has primarily insisted on drastic cost-cutting in the highly indebted countries. However, this in itself will resolve neither the debt crisis nor the euro crisis. For this reason it is a fact that in one way or another Germany is going to have to make a financial contribution if it wishes to redress the economic and fiscal imbalances in Europe. If individual eurozone states were to become insolvent, losses would be incurred by the European Central Bank (ECB) and the commercial banks. The same is true of debt write-downs. The losses incurred by the ECB and the cost of safety nets for banks the might become necessary will be borne by the German taxpayer. Estimates published by Spiegel Online indicate that total default by Greece would confront the German taxpayer with write-offs amounting to €60 billion, and this does not include the contagious influence such an event might have on other ailing eurozone states (see Kwasniewski 2012). The insolvency of one country will be bound to fuel speculation about the possible bankruptcy of other eurozone states, and rising interest rates will simply increase their indebtedness. Furthermore, sovereign default will lead to a catastrophic economic implosion in the country concerned, and this, on account of the degree of economic interrelatedness, will quickly spread to other European countries. Since it is an exporting nation, this would have a severe impact on Germany. A drop in exports would lead to a decline in employment, and this in turn would lead to lower government revenues and higher government expenditure.

It thus follows that as far as German taxpayers are concerned the current crisis in the eurozone is going to cost them something whether they like it or not. However, if the crisis is going to cost something come what may, it makes more sense to use the money preventively in order to bolster economically weak countries and to prevent a collapse of government finances and the economy. These payments would in so many words be the price for stable economic conditions in Europe and the stabilization of the monetary union. This is of fundamental importance for Germany as an exporting nation as it strives for job security and prosperity. The latest report by the German Council of Economic Experts comes to clear-cut conclusions which deserve our unqualified support. “Germany more than any other country has profited a great deal from the monetary union. . . . Those who wish to benefit from the advantages of open markets for goods and services will have to ensure, in the context of global financial and investment networks, that the instability emanating from them does not cause serious damage to the real economy. Such protection is not going to be free” (SVR 2011, p. 2). ■

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