# WHAT BALANCE BETWEEN AUSTERITY AND GROWTH IN THE EURO ZONE?

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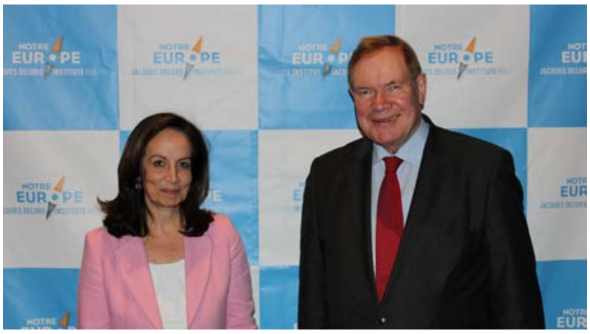
*Notre Europe – Jacques Delors Institute* publishes the synthesis of the round table entitled "What balance between austerity and growth in the euro zone?" organised during the annual meeting of its European Steering Committee on 24 November 2012. Taking their cue from an introductory speech by former Greek minister and EU commissioner Anna Diamantopoulou and by former Finnish Prime Minister Paavo Lipponen, the participants discussed the lessons to be learnt from the euro zone crisis and formulated key guidelines for financial stability and growth.

The debate began with an **overview of the euro zone's situation today** (1) and of **the lessons to be learned from the way in which the crisis has been managed over the past three years** (2). Following this diagnosis, several proposals were formulated for **restoring financial stability within the euro zone** (3) and for **imparting a fresh boost to Europe's economies**, especially to the economies of countries currently benefiting from financial assistance (4). And lastly, the participants viewed **two instances of successful economic recovery**, namely Finland and Latvia (5).



## 1. The euro zone three years after the crisis began

In the three years since the crisis began, **the euro zone has adopted new instruments for financial stabilisation** (the European Financial Stability Facility – EFSF and the European Stability Mechanism – ESM) which to date have benefited Greece, Ireland, Portugal and Spain. At the same time, **the member states have undertaken a reform of the EMU** by strengthening its economic, budgetary and banking pillars.

Despite these important steps forward, **the economic, social and political situation in the euro zone has deteriorated over the past three years.**

### 1.1. A euro zone over-indebted and in recession

**Growth is not materialising in the euro zone**, in fact GDP shrank by 0.1% in the third quarter of 2012. It is true that it is first and foremost the countries currently receiving financial aid or under pressure from the markets that are suffering from a major recession (apart from Ireland, which saw a return to growth in 2011). Yet the euro zone's "virtuous" economies are also having problems boosting their economies, their growth rates having been on a downward trend since 2010.

**Greece's economy has shrunk by approximately 20% in four years**[1]. And Eurostat has forecast a 4.2% recession for 2013, placing Greece in a situation similar to that of the United States back in the days of the Great Recession in the 1930s, when the country's GDP dropped by 27%.

But quite apart these negative growth results, the priority which member states have afforded to fiscal consolidation has failed to produce any particularly visible results. **Average public indebtment in the euro zone's member countries rose from approximately 80% of GDP in 2009 to 90% of GDP in the second quarter of 2012.** Greece's indebtment rose from 130% of GDP in 2009 to 150% of GDP in the second quarter of 2012, despite approximately 100 billion euro in debt held by private creditors having been written off early in the year.

### 1.2. Citizens without hope: unemployment, social unrest and social break

After three years of crisis, the unemployment rate, particularly with regard to jobs for young people, has risen throughout the euro zone. **The countries of southern Europe are facing a deep and dangerous social crisis**, as borne out by statistics: **the overall unemployment rate in Greece and Spain stands at over 25%, while youth unemployment is hovering around the 55% mark.** One of the consequences of the problem regarding youth unemployment is the brain drain from southern European countries, towards Germany in particular.

Moreover, **the southern European countries are experiencing growing social unrest**, because the man in the street no longer accepts the austerity measures being implemented. The citizens of those countries have lost all hope and they fear that an entire generation may fall victim to this crisis.

### 1.3. A crisis that fuels the rise of extremist parties

**The crisis has created an environment favourable to the rise of far-left or far-right parties in several European countries**, particularly in Finland where the far-right party True Finns became the third largest party in the country in 2011 after garnering fully 19% of the votes in the parliamentary election (as opposed to a mere 4% in 2007).

**Yet it is in Greece that the political picture has changed the most since the start of the crisis**. PASOK and Nea Demokratia had been the two main political parties in Greece for the previous forty years, accounting for approximately 80% of votes prior to the crisis. In the most recent election, in June 2012, they garnered 12% and 18% of the vote respectively. Today the voting intention polls suggest that **far-left party Syriza is the main political party in Greece, while far-right Golden Dawn is the country's third largest political force**, accounting in surveys for fully 14% of the vote.

## 2. The lessons to be learned from three years of crisis management: Greece as a case study

Greece's situation has deteriorated over the past three years and this has had a contagious impact on other fragile economies in the euro zone. This highlights the shortcomings in the approach adopted by Europe's leaders in managing the crisis. In order to correct that approach, it might be useful to draw a few lessons from it[2].

### 2.1. The public debt sustainability issue

The member states' priority ever since the start of the crisis has been to prevent debt restructuring in the euro zone member countries; and this, despite the fact that numerous studies have shown that **the Greek debt is not sustainable**. Debt levels over 100% of GDP are unsustainable because if the country is to return to below the threshold of 60% of GDP, it does not need a balanced budget – which is difficult enough to achieve in itself – but a budget with a 2% of 3% surplus for ten years.

In view of the deterioration in Greece's situation, despite the financial aid afforded to the country and the implementation of a fiscal consolidation and structural reform programme, the member states finally recognised **the need to alleviate the burden of the Greek debt**. A partial restructuring plan agreement was thus forged, enabling the Greek debt to be written off to the tune of approximately 100 billion euro. **Yet even then, standing as it does at 150% of GDP, Greece's debt is still at an unsustainable level.**

The member states should have addressed the issue of the sustainability of Greece's debt, and indeed of the debts of other countries in difficulty, from the outset. Today, **the debt stock run up by the member states is still a problem and there is a risk that the countries will not be able to emerge from the crisis despite all of the efforts being made**.

### 2.2. Failure to take the reforms on board at the national level

Greece's political leaders have had a **problem with confidence and credibility issue** since the start of the crisis. This lack of confidence and of credibility is due largely to the fact that, despite having agreed to the programme signed with the Troika, **the Social Democratic government failed to take on board the reforms that it was supposed to implement** and it maintained a certain distance from the austerity measures being implemented in Greece. The government failed to support the reforms in public, and in addition, it also had to face broadsides from the opposition parties that did not subscribe to the commitments made with the Troika. Consequently, neither the civil service nor the citizens have taken the reforms on board, and that has made their implementation that much more difficult.

### 2.3. A country cannot be restructured as though it were a business

**The Troika has enforced a fiscal consolidation programme on Greece which the OECD considers to be one of most massive such programmes ever devised.** At the same time, **some very in-depth structural reforms have been stipulated**, especially in the country's pension, health, education and financial systems.

The first financial aid programme granted to Greece in May 2010 points up the illusion that a country with serious problems in the areas of public indebtment, competitiveness, employment and growth can be restructured in the space of a few years. The Troika thought that a country could be restructured as though it were a business. But **a country is not a business because it has citizens, a culture and habits. A country cannot be restructured in three years because it is impossible to act in all of the spheres at once, and above all, it is necessary to take the measures' social impact into account.** It was obvious from the outset that the goals were too ambitious and the timetable too tight.

### 2.4. The inadequate implementation of structural reform

**It is a feature of structural reforms that they come at a great cost at the start and produce results only in the longer term.** Furthermore, structural reforms' success does not depend on their adoption but on their implementation, yet implementation takes time and it demands that governments show no let-up in their efforts along the way. By the same token, leaders need to be able to count on their civil servants' participation in the reforms, and that is not happening in Greece.

Structural reforms are simply not accepted in the very difficult political and social environment in Greece. **Even if the government adopts reforms, it is very difficult for it to then achieve positive results because their adoption is not followed by their implementation.**

There are, in particular, two key areas for the Greek economy in which very little progress has been made. There is the **reform of the civil service** – which is top-heavy and needs to be modernised – **and the reform of the tax system** which is necessary to effectively combat the tax evasion that is one of the country's most serious problems.

### 2.5. What success in a context of economic recession?

Fiscal consolidation and the implementation of structural reforms are, of course, two essential conditions for Greece to emerge from the crisis. Yet when austerity starts to curb growth, the deficit and debt reduction effort no longer produces the results hoped for. **Given that the evolution of the debt-to-GDP ratio depends not only on the evolution of the debt but also on the evolution of GDP, if GDP shrinks, it nullifies the fiscal consolidation effort.** In this connection, Greece has been in deep recession for the past four years.

Europe's decision-makers have gradually taken this fact on board over time and they have introduced growth into the European agenda. It is obvious today that **it is no longer possible to go any further in the fiscal stringency effort being demanded of Greece; the question that arises, therefore, is how to get the country out of recession and how to accompany the implementation of its structural reforms?**

## 3. Restoring financial stability in the euro zone

Standing staunchly by austerity lay at the heart of Europe's strategy to restore financial stability in the euro zone. Now that that strategy has shown its shortcomings, it must be completed if it is to restore financial stability and to permit a fresh boost to growth in the euro zone.

### 3.1. Restoring credibility and confidence

The credibility of Europe's political word has been heavily undermined by the way in which the crisis has been managed. **Member states have not so**

**much acted as reacted, and there has been disharmony among Europe's leaders in their public statements**, with numerous remarks being made to the effect that Greece should quit the euro zone.

The fear that Greece might quit the euro zone fuels capital transfer abroad, which then worsens the banking system's problems and discourages investors. The government, for its part, needs to spend its time explaining that the country is not going to quit the euro rather than focusing its communication efforts on the reforms under way.

It will not be possible to impart a fresh boost to growth in such an unstable environment for the euro zone and for Greece. The crucial element for restoring stability in the euro zone, therefore, is to **regain investors' confidence, and that demands both categorically ruling out the possibility that the euro zone may collapse and engaging in an ambitious and credible plan for emerging from the crisis and for reforming the EMU.**

### 3.2. Addressing the problem of excessive indebtment in the euro zone member countries

The euro zone has an indebtment rate that stands at 90% of its GBP. If its member states wish to strengthen the credibility of their action, they need to adopt measures allowing them to redeem the debt they have accumulated, which has risen above the threshold stipulated in the Stability and Growth Pact.

Today, while the peripheral countries have suffered unsustainable interest rate hikes, **Germany and France, among others, are borrowing at all-time low rates**, because investors are tending to pull out of the southern European countries and to fall back on them. Rather than intervening after the countries have lost access to the markets, **the member states should adopt instruments capable of allowing those countries to continue to finance their requirements on the markets at reasonable rates.**

To this end, the member states should take their inspiration from the initiative adopted by Alexander Hamilton, who proposed a system based on debt mutualisation in the United States in order to forestall the bankruptcy of those states that had run up excessive debt. The five German wise men based their work on this American experience when they submitted their proposal for the establishment **of a debt redemption fund allowing the mutualisation and redemption over 20 to 25 years of debts accumulated by member states above the threshold of 60% of GDP**. Excessive indebtment is a problem shared by most of the countries in the euro zone and thus it deserves a common response.

### 3.3. Boosting the implementation of structural reforms and of privatisation in the countries under market pressure

Member states currently benefiting from financial aid must continue with their efforts to consolidate their budgets and to implement structural reforms. **If they are to strengthen the credibility of their actions, national leaders need to take on board the measures which the Troika suggests they adopt.**

In addition, **the countries of southern Europe must focus on privatisation**, a process which brings with it a dual benefit. On the one hand it **helps to bring down budget deficits**, thus contributing to the consolidation of public finances; while on the other, it allows the privatised companies to enjoy better management, and that it turn triggers other positive external effects, in particular **an improvement in the country's economic competitiveness**.

## 4. Putting growth back in the heart of Europe's priorities

In order to impart a fresh boost to Europe's economies, member states must pursue their efforts to consolidate their budgets and to implement structural reforms; yet their action in that sense must be combined with concrete and ambitious initiatives designed to stimulate growth, and that is what has been missing to date.

The EU has an important role to play in promoting growth because, as Tommaso Padoa-Schioppa used to argue, **"austerity for the states, growth for the**

**EU"**. A series of measures have been put forward in that sense. It was also pointed out that those countries currently in a more favourable position should contribute at the national level to the economic recovery of the euro zone as a whole.

### 4.1. Implementing the "Compact for Growth and Jobs"

The Compact adopted by the heads of state and government in June 2012 provides for the **mobilisation of 120 billion euro to foster growth and jobs in Europe**. Almost six months have gone by since its adoption, yet it has produced no visible results to date.

**The decision to increase the European Investment Bank's capital** (EIB) to the tune of 10 billion euro, thus making it possible to mobilise a further 60 billion euro in additional loans, **will only be formally adopted at the end of 2012**, which postpones all recourse to this additional loan capability until 2013.

**As for the reprogramming of structural funds,** which account for 55 billion euro of the funds provided for in the Growth Compact, **they have not even begun to be mobilised** fully five months after the European Council meeting in June.

While a great deal of criticism is being levelled at Greece for taking its time in implementing the reforms that it adopts, **the European institutions and member states need to set the example by rapidly implementing their decisions.**

### 4.2. The single market as a driving force for growth

Despite also being mentioned in the Compact for Growth and Jobs, the enormous potential represented by the single market has not yet been fully exploited. Given the rising unemployment in Europe, the rationale of economic integration and of the opening up of its markets may be called into question by the continent's citizens. In order to address this issue, the completion of the single market must be based on the compromise proposed in the Monti report in 2010. **The single market cannot be built only on a single leg, namely on deregulating the movement of goods, services and capital; its social aspect must also be strengthened.**

In addition, the member states should reflect on the need to adopt **a European strategy designed to combat the anti-competitive practices** employed by some of the EU's economic partners, with China heading the list.

### 4.3. Supporting small and medium-sized enterprises in countries receiving financial aid

**The financing of small and medium-sized enterprises (SMEs) is crucial in order to kick-start growth, to save jobs and to create new ones, as well as to strengthen the competitiveness of those countries currently benefiting from financial aid.** The EU has a role to play in ensuring that SMEs from those countries have access to liquidity, and in lowering their financing costs.

Banks in Greece no longer have any money to lend to Greek enterprises. And those enterprises that do resort to loans despite everything, are being asked to pay interest rates which are two to three times higher than the rates being paid by enterprises in other European countries. **In order to address this issue, the Commission, the Greek government and the EIB signed an agreement early in the year providing for the creation of a guarantee fund in support of SMEs.** This fund, comprising 500 million euro from unused resources in the structural funds assigned to Greece, was intended to guarantee the loans that the EIB would grant to Greek SMEs through partner banks in Greece, for a total of 1 billion euro.

Yet the EIB has been delaying in implementing this agreement in recent months because it fears that it might be excessively exposed to the Greek crisis, thus the results hoped for have not been achieved. **It is urgent to make this guarantee fund operational and to provide a flow of liquidity to the real economy through the EIB.**

### 4.4. Adopting a pact for entrepreneurship in Europe

**The climate in the European economy is not right today for creating any major new enterprises.** Only twelve major new European enterprises have been created since 1950 whereas, for the sake of comparison, some 500 have been created worldwide, fully 52 of which have been created in the United States alone. While young entrepreneurs in China and Brazil account for 15% of the population, and for almost 8% in the United States, they account for only 2.3% of the population in Italy and for 4.2% in Germany. Moreover, the European economy as a whole is dominated by traditional sectors which invest less in R&D and in innovation.

In view of this, **it is urgent to adopt a pact for entrepreneurship in Europe** in order to remedy some of the European economy's principal weaknesses. The pact should include, in particular, measures **designed to strengthen the culture of entrepreneurship, to improve access to capital and to simplify the bankruptcy regime**. This commitment on member states' part to promote and facilitate entrepreneurship would make an important contribution to kick-starting growth and to creating jobs in Europe in the medium term.

### 4.5. Tackling the brain drain and youth unemployment

The countries of southern Europe are facing a serious youth unemployment problem, which is causing a brain drain. **The European Union should help member states to devise a response to this problem by redeploying part of the European Social Fund to support youth employment.**

### 4.6. Promoting recovery policies in the countries not under market pressure

Those countries not under market pressure must be urged to implement economic stimulus policies. But having said that, **given that most of the countries in the euro zone are over-indebted** and therefore need to consolidate their public finances, **they are unlikely to be in a position to adopt an income tax reduction policy. The alternative is to raise wages**, and indeed that is already happening in Germany, where certain areas of industry have recently experienced wage hikes to the tune 4 or 5%.

Member states should also contribute to strengthening the single market by combating whatever corporatism may exist in their economic systems. **The adoption of these deregulation measures will make it possible to free up the growth potential in "closed-shop" areas of business while, at the same time, facilitating the completion of the single market.**

## 5. Economic recovery after a serious economic crisis: two instances of success

Finland and Latvia offer two instances of countries which have rapidly and successfully imparted a fresh boost to their economies in the wake of a serious economic crisis. Even though their experience cannot be reproduced in Greece or in the other countries in difficulty, we may still draw some useful lessons from it.

### 5.1. Finland: from the crisis in the 1990s to world leadership in competitiveness in 2002

The Nordic countries experienced a severe economic and financial crisis in the early 1990s. **In the space of three years, Finland's GDP shrunk by almost 13%, its unemployment rate shot up to almost 20% and its public debt trebled.**

In view of the magnitude of the crisis, **the Finnish authorities adopted strong austerity measures and implemented in-depth structural reforms, thus restoring market confidence.** Thanks to massive investments in research and innovation, to the explosion of the ICT sector and to significant productivity increases, Finland became a global model of advanced technology and competitiveness in the 2000s.

Finland's experience shows that fiscal consolidation and structural reforms are crucial to economic recovery. Having said that, however, the country benefited from three circumstances which are not part of the equation today for the euro zone countries currently in difficulty:
- First of all, **Finland devalued its currency** right at the start of the crisis in 1991, which allowed it to boost its exports.
- Secondly**, Finland's public debt before the crisis accounted for only about 20% of its GDP**.
- And lastly, it implemented its reforms in **a context of economic growth** (at both the global and European levels), which is not the case today.

### 5.2. Latvia's success story in the wake of the global financial crisis in 2007

The major impact that the global financial crisis had on Latvia forced the country to seek financial assistance worth 7.5 billion euro from the EU, the IMF and the World Bank. The implementation of a fiscal adjustment programme worth some 15% of GDP over three years plunged Latvia into **a major recession – its GDP shrank by almost 25% – and unemployment affected fully 20% of the active population.**

**Latvia returned to growth in 2011 and it is now one of the three countries with the highest growth rate in the EU.** This spectacular economic boom is due largely **to the government's determination and to the fact that the leaders and citizens took on board the austerity measures adopted.**

Latvia is not in the euro zone, yet it did not take advantage of the chance to alleviate its adjustment burden by devaluing **its currency**, which **remained pegged to the euro**. The main advantage that Latvia had over the countries in the euro zone currently receiving financial assistance, is that the latter are over-indebted while **Latvia's public debt stood at approximately 20% of its GDP before the crisis** (that debt now stands at approximately 45% of its GDP in the wake of the crisis). And lastly, it is worth highlighting the fact that, despite its success, Latvia has nevertheless experienced major emigration on the part of its young labour force, **losing almost 10% of its population since 2000**.

1. -3.1% in 2009, -4.9% in 2010, -7.1 in 2011 and -6% expected in 2012, according to Eurostat.
2. See Anna Diamontopoulou, "A new path for growth and solidarity", *Tribune, Notre Europe – Jacques Delors Institute*, December 2012.

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