The euro area crisis and future global implications

Speech by Dr. Wolfgang Schäuble, German Federal Minister of Finance
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Ladies and gentlemen,

For more than two decades, economic policy in industrialized countries has tried to avoid recessions sacrificing fiscal prudence and monetary rectitude in the process. When financial markets crashed, central banks, particularly in anglo-saxon countries, cut interest rates. And when growth declined, governments plundered the public's purse - even worse they robbed children's piggy banks - to make up for the private sector's reluctance to spend freely.

One result of such misguided policies was a series of debt-financed asset bubbles. For me it is no coincidence that the last of these financial crisis started in the United States and its real-estate sector. US policymakers attempted to support high levels of growth via monetary policy. They tried to promote home ownership of poorly skilled workers by having less stringent lending practices. The former IMF chief economist Raghuram Rajan analysed that problem in parts lucidy when he argues in his recent book that America's growing inequality and thin social safety net create tremendous political pressure to encourage easy credit and keep job creation robust - no matter what the consequences to the U.S. and world economy are.

Now, I am not here to blame U.S. economic policy. And helping the poor and undereducated is a worthy goal. But lax monetary and lending policies are no replacement for good education and social policies. And while there are indeed adverse incentives in the social market economy, I would argue that - as a system partially designed to alleviate social inequity by a mix of income redistribution and accessible education - it is superior to the US model which uses monetary and lending policies to soften inequality.

Back to the financial crisis. When the last of those debt-financed bubbles burst three years ago, governments had to up the ante and use massive fiscal stimuli and central banks had to take resort to unprecedented measures of easing monetary policy to avoid the breakdown of financial markets and an ensuing depression.

To be fair, those measures have been necessary to avoid a depression. But Keynesian deficit spending has had unfortunate consequences: Governments' debts and deficits are on the verge of spiralling out of control. At least markets think so, withdrawing their confidence and demanding higher risk premiums, i.e. interest rates.

Governments are now faced with a predicament. There is little political or market appetite for more fiscal and monetary stimuli. But markets and citizens do not crave tighter fiscal and monetary policies either, for fear of their economies heading back into recession.

There is a feeling that politics is at wit's end. And in a sense that is true: Governments and central banks have used up much of their fiscal and monetary firepower. I think it is no accident that unemployment in the U.S. has remained stubborn despite all the efforts by the Federal Reserve and the United States government to promote growth. We will not spend our way out of the current predicament, nor will it work to lower the debt burden by inflating the problem away. Loosening monetary and fiscal policies in the short-term while promising monetary and fiscal tightening in the medium-term might have worked in the past.

Today however, as market reactions demonstrate, it lacks credibility with investors as well as with our citizens.

The key question today is: What is the alternative to those boom and bust cycles of the past, caused by and in turn causing overleveraged public and private sectors? Is there an alternative economic policy framework?

I would argue that we can establish an alternative economic policy framework - a framework that does not encourage laissez faire economic policies of the recent past nor the discretionary meddling in economic affairs of the seventies, but nevertheless will not lead to marginal economic growth in tightly regulated markets; an economic policy framework which fosters sustainable growth.

I am convinced that we can establish fiscal and financial policy frameworks that encourage long-term sustainable growth of the economy instead of short-term volatile growth bursts or long-term economic decline. But for this to happen, immediate fiscal consolidation and structural reforms in highly indebted countries are of the essence. Public debts and deficits in a number of industrialized countries are too high and we need to bring them down fast. Markets no longer accept current debt and deficit levels and they no longer accept that governments put economic reform of until after the next election.

Recent studies - most prominently Rogoff's and Reinhardt's book "This Time Is Different" - , have shown that once government debt burdens reach thresholds perceived to be unsustainable, more debt will stunt rather than stimulate growth. Investors as well have reached the conclusion that debt and deficit levels in a number of countries are unsustainable and expect governments to bring them down - now.

There are some who argue that fiscal consolidation, a smaller public sector and more flexible labor markets will lead to a decrease in consumption in these countries in the immediate future. I am not sure that's necessarily the case, but even if it were, there is a trade-off between short term pain and long term gain in these countries: I would argue that an increase in consumer and investor confidence and a shortening of unemployment lines will in the medium term cancel out any short-term dip of consumption. I am not deluding myself, however and neither should you: It will take not months but years, before these efforts will bear fruit.

Given the time necessary to bring public debts and deficits down to sustainable levels in Europe, we will have to provide strictly conditional financial assistance to highly indebted and less competitive member countries. In essence we are buying those countries the time they need to put their public finances on a sustainable footing and improve their competitiveness.

One of the major problems of most of these countries is their large current account deficit, exposing their lack of competitiveness and strong dependency on imports. A key question therefore is: What effect would fiscal adjustments have on countries' external balances? Well, the IMF looked at fiscal policy changes over the past 30 years in advanced economies. What they found was that fiscal policy has a large and long-lasting effect on the current account. And the improvement in the current account takes place not just because imports fall as a result of lower consumption and investment. They also found that exports rise as the real exchange-rate will depreciate.

That finding is true for countries where the exchange rate is fixed as well. Of course, as the real exchange-rate depreciates, domestic wages and prices will have to adjust.. And these adjustments are painful, no doubt. But that is why in the case of Greece we are providing financial assistance and allow Greece to prolong the adjustment period to accommodate social hardships. Now there are a number of economists who argue that it will be easier politically to deal with nominal real exchange rate adjustments. Well, they should not fool themselves.

No, the key question for the Eurozone is: Can we establish and adhere to a framework for the economic governance of the Eurozone that encourages long-term sustainable growth of our economies instead of short-term volatile growth bursts or long-term economic decline? I think we can. But every journey starts with the first step: For this to happen, immediate fiscal consolidation and structural reforms in Italy, Spain, Portugal and Greece are of the essence.

Ladies and gentlemen, only calling for more budgetary discipline will be insufficient. We have to repair public finances, but we have to do so in a way that rather encourages than hinders future growth. Governments need not only convincingly demonstrate their commitment to fiscal consolidation but also to increasing competitiveness to restore confidence of markets as well as their citizens.

Let me repeat that: The challenge for governments today is not to repair public finances. It is not even to start repairing public finances immediately. It is to restore the trust of investors and citizens in the sustainability of their governments' fiscal policies and foster sustainable growth in the long run. Otherwise the financial, economic, social and political consequences of an ensuing crisis of confidence would be dramatic and difficult to contain.

Some argue that such a demand for sustainable growth is eurocentric and something only wealthy European countries can afford. Others even argue that it is a sinister strategy by well-off nations to stop developing nations from gaining ground.

Well, nothing could be further from the truth. Developed as well as developing nations alike - at least most of them - learned a hard lesson the last three years: Namely, that long-term gains have been consistently postponed or forsaken for short-term gratification, that fiscal and financial policies are off-track and unsustainable .This time we will have to take the long view: Developed economies need - and are in the process of - de-leveraging. It is not only households who have to live within their means, who – at least in the long run - cannot spend more than they earn, it is countries and it is citizens as well.

Recent events have shown that a common currency cannot survive without solidarity between its members. But such solidarity has its limits, it can only accompany a country's reform efforts, not replace them: A member state has to be willing to deal with the root causes of its problems itself, European solidarity cannot replace a governments resolve. But it is not only highly indebted countries that have to change. Brussels has to change its bureaucratic ways as well. Perhaps it is no accident that enthusiasm for the European idea has been fading while the Commission's staff - and their pay - has been steadily increasing. But for Europe and its members to become more efficient, their bureaucracy has to become more effective and less self-absorbed. Helping those countries which are most in need by realigning their spending priorities to foster sustainable growth could be a start.

It is indeed vital, that we look at more than just government budgets, debt and deficit figures. We must consider an individual members' economic performance too, improve competitiveness and better co-ordinate economic policy.

And while we are talking about improving competitiveness: Yes, we have to avoid overly large imbalances between member states. But no, this cannot take the form of successful countries voluntarily limiting their competitiveness. The only workable course is for those countries in the Eurozone who are somewhat weaker, to become stronger. We can help them, but we cannot do their job. One does not resolve one's own problems of competitiveness by asking others to become less competitive and one cannot permanently close the gap between expenditure and income by asking others for money.

I am well aware that growth rates in Europe will vary, notwithstanding our best efforts to improve competitiveness. While not a zero sum game, growth in the more mature economies of Western Europe will not keep pace with growth rates in a number of Eastern European countries, not least for demographic reasons, but also because of pent-up demand in those countries. But that is not a bad thing at all: If you ask me: What is Europe's contribution to global prosperity? It is our emphasis on long-term, stable and sustainable growth. I would even argue that gearing economic policies towards that goal is worthy of consideration even in those economies in Asia and South-America which are more dynamic than the mature economies in Europe.

I think the core lesson from the past crises is that high cyclical, credit-fuelled growth, which is driven by the financial market, does more harm than good. Instead, we need to create the preconditions for lasting and sustainable growth: Sustainable growth defined as steady, environmentally-friendly and socially-compatible growth propelled by the industry and productivity of the real economy and not by an overleveraged financial sector.

I am convinced that, if we stick with our policy of fiscal and structural reforms, we will put the economies of the Eurozone on a sustainable footing and prevent the debt crisis of some countries from becoming a crisis threatening the Eurozone as a whole and in turn the world economy.

Now, there are some, who are not satisfied by the way European politicians are dealing with the crises, who are now calling for the supposed structural faults in European Monetary Union to be corrected once and for all by building up the political and fiscal union. But that is an approach that does not reflect the genesis of European integration. Europe always moved forward one step at a time. And it will do so in future as well. I am a great fan of Karl Popper and his concept of an open society which improves through a constant process of trial and error. If we want to draw the right lessons from the recent crises, then that is how we have to proceed.

But there is time for little and there is a time for bold steps. And the time for bold steps is now. Governments in the Eurozone need not just to commit to fiscal consolidation and improved competitiveness and governance, they have to deliver. And they will. We will strengthen the institutional links between the common European monetary policy and the still national responsibilities of member states for fiscal policies.

I believe that it will become increasingly necessary for European democracies to strengthen the bond between its citizens and Europe on each step of the way by strengthening the democratic mandate of European institutions. However, that does not mean that the fiscal and monetary policy decisions taken by these democratically legitimated institutions need the public's continual approval of their decisions. As I understand it that squares with an insight of constitutional economics: That you establish and legitimate your principal monetary - and fiscal - institutions with a strong democratic mandate but entrust them to conduct monetary and fiscal policy as independent from politics as possible. Of course these institutions will still make mistakes, but at least mistakes based on error-prone interpretations of the public mood should not be one of them.

Ladies and gentlemen, to sum things up: To regain credibility, immediate fiscal consolidation and structural reforms in highly indebted and non-competitive countries are of the essence, even as the returns on that investment are one, perhaps two election cycles away. Europe has begun to create a framework that promotes the sustainable growth of the real economy. A framework which encourages more responsible behavior on the part of European governments and - by the way - of financial market participants as well. Strengthening the institutions of the Eurozone may need treaty changes and will take time. But make no mistake about it: The direction is undisputed, as is the decisiveness of all member states to defend the common European currency. We will form an ever closer European Union, contributing to European prosperity and global stability in the process. Thank you very much!