Even Germany Faces Limits

It's time the eurozone faces reality and cleans up its public finances.

By Kurt J. Lauk

The debate over the right measures to tackle the EU sovereign debt crisis is increasingly drifting towards the opacity of debt postponement. The proposals revolve around the size of the rescue packages, leveraging the European Financial Stability Facility, eurobonds, and even an all-powerful ECB money machine. However, all these approaches have one huge flaw: They assume that heavily indebted governments will refrain from excessive spending and return to the straight and narrow path—willingly and without any supervision to speak of. At the same time, the markets, which clearly doubt that these governments are prepared to implement reforms and reduce spending, need to be convinced that this change of heart will really take place. These assumptions are not very realistic.

It is becoming increasingly clear that the so-called rescue packages enacted between May 2010 and November 2011 have not had any appreciable impact. Each assistance pact has been sold by policymakers as the only possible solution. In reality, they have served to exacerbate and put off the crisis. The emergency rescue measures hastily cobbled together by the European Union ultimately could not stop the problem from spreading. We need to understand that bailouts and guarantees will be no help until the problem has been attacked at its root.

The recent resolutions go a long way towards communitizing risks caused by unsound public finances and misguided macroeconomic policies in individual euro area countries, without this being offset by

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any concrete powers to intervene in the sovereignty of national fiscal policies. The German federal government will therefore resist any further transfer of sizeable risks to the countries providing assistance and their taxpayers. It is insisting on three red lines: no eurobonds, no unlimited purchasing of government bonds by the European Central Bank, and no increases to the bailout funds. All three points are justifiable and right. However, there is growing doubt over whether the German government can maintain all three positions simultaneously.

Germany is already contributing €211 billion to the European Union's EFSF bailout fund. EFSF leveraging further increases the risk of losses. The introduction of the European Stability Mechanism will be the next step towards joint liability. Germany will contribute €22 billion in cash. It will have to borrow that money from the capital markets and pay interest on it amounting to millions every year—after all, Germany does not have a budget surplus.

In addition, the European Central Bank is pushing Germany to take on ever-greater liabilities without democratic legitimation. The ECB has increasingly been buying government bonds from southern European countries, €196 billion worth since May 2010 alone. Germany is responsible for over €52 billion of that, according to the ECB capital key. With France losing its triple-A rating, even French bonds could soon turn up on the ECB balance sheet. And yet that is only the tip of the iceberg. Around €600 billion more is at stake in the Target 2 system, which central banks use for cross-border transactions in the eurozone. The German Bundesbank alone is responsible for €500 billion of that sum.

If the European Central Bank continues to clean up the mistakes of governments, it will destroy its independence and harm its credibility in the quest for price stability. There is clearly a dramatic lack of proportion as regards the voting rules in the ECB Governing Council. When deciding on bond purchases the rule is one member, one vote. Yet when it comes to liability, the ECB capital key is used. Then Germany must suddenly assume 27 percent of the liability for all decisions.

All the measures taken to save the euro so far have been taken because Germany refuses to accept eurobonds, and rightly so. Eurobonds utterly fail to address the causes of the crisis. They give bankrupt governments absolutely no incentive to carry out the reforms that are urgently needed to improve their economies. Eurobonds would visibly cement community liability for European debt while at the same time shifting the relevant administrative competence to EC institutions such as the European Commission and the European Parliament.

Despite Chancellor Merkel's protests, European Commission President José Manuel Barroso recently presented a detailed Commission paper on the topic. Eurobonds are now called stability bonds, but the new name does not make the idea any better. On the contrary, Barroso's plea to introduce eurobonds is dividing Europe. In view of the already tense atmosphere, his proposal is a slap in the face for Germany and other economically sound countries.

At the same time, Barroso's initiative reveals the serious deficits in EU governance. With all European control mechanisms, we have a dangerous situation in which those who profit from transfers are in the majority. Thus an

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—*K. Lauk*

José Manuel Barroso

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overwhelming majority in the European Parliament and the European Commission are in favor of eurobonds. This is why Germany wants decision-making powers to remain intergovernmental, that is, in the hands of the Council of Europe. That is the best place for Germany to defend its interests; its weight there effectively amounts to a veto.

Yet the German federal government's clear stability position has now led to European debt and risks being communitized non-transparently, through the back door. Many members of the eurozone are either not willing or not able to accept strict fiscal discipline. The "German diet" of resolute cutbacks and painful structural reforms is not to their taste. Shared liability seems more palatable. Their commitment extends no further than nice words and good intentions. This isolates Germany politically yet still forces it to accept liability.

At this historic crossroads, we have two choices: Either we risk the default of heavily indebted member states, or the European Central Bank finances public debt via the money printing press. Monetary financing may appear to be a solution, but it has dangerous side effects. It undermines the incentives for sound public finances and creates an appetite for ever more of that sweet poison. With time it leads to inflation—even if the ECB attempts to "sterilize" its government bond purchases by siphoning liquidity from somewhere else. When the interest rate on Italian bonds rose, Italy passed reforms very quickly. But when the European Central Bank began buying, Italy's willpower withered immediately and it reversed some of those urgently needed reforms. As we can see, the market teaches discipline and should thus not be left out of the equation, especially since the alternative is to palm off the risks on taxpayers in individual countries. The European Central Bank has no authority to redistribute risks in this way.

There is no question that it would be undesirable for even one country in the eurozone to default. But delaying an inevitable default is far worse and far more expensive. If we allow insolvent countries in the eurozone, we will turn the euro into an uncontrollable virus. Insolvent countries must either undergo restructuring and give up some of their sovereignty during the restructuring process—so budgetary discipline can be enforced—or else they must submit their resignation from the eurozone. A normal scenario would punish poor economic performance with a weak currency, but the eurozone has effectively replaced the exchange rate mechanism with extreme spending cuts, leading to recession and haircuts. Yet Europe will not be able to withstand multiple haircuts. If the countries in the eurozone do not agree to primary surpluses within a foreseeable period, this could become a never-ending story.

The EU sovereign debt crisis has caused a shake-up of the continent's governments. Seven out of seventeen countries that use the euro have already removed a head of state. Political failure can no longer be covered up. Greece and Italy have already handed political responsibility over to the technocrats. For years, the empty promises of new social benefits were based on new borrowing instead of economic performance. We have sown social programs and are now reaping mountains of government debt. Meanwhile, Germany too continues to be overly generous in its spending, whether it's in regard to childcare subsidies, a minimum wage, or massive subsidies for renewable energy. Reading up on Ludwig Erhard a bit might have helped avoid this misguided development. The father of the German economic miracle taught us that the state can only give its citizens what it has previously taken from them through taxes and levies.

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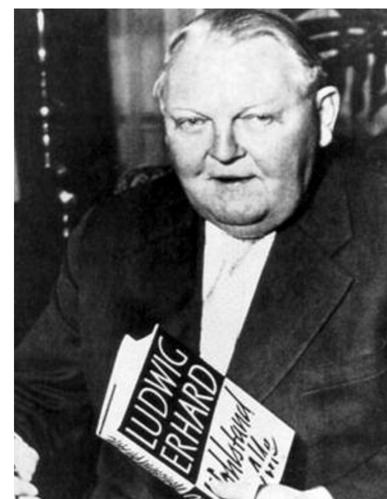
Europe's system of social largesse has reached its limits. Did the finale really have to be so dramatic? No. If we had used our yellow and red cards as we should have during the past ten years, this predicament never would have occurred. Yet the good rules that we laid down for ourselves were knowingly disregarded. And now we see that



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Europe cannot function without a red card, and are witnessing a dramatic U-turn in European politics. Our fairytale Europe, where a lack of self-discipline was neither censured nor punished, is now coming to a dead end. How will the monetary union ever rebuild confidence if its legally established principles cannot be relied upon?

Germany is ultimately the guarantor for all these rescue measures. If Germany loses its triple-A rating, the measures will all crumble. We need to use this muscle to get to the heart of the crisis. The causes lie in the indebted countries, and the solution must come from them as well. A policy of debt can no longer be an option in the future. We will only be able to achieve this with strict, binding agreements for reducing debt in the eurozone. Every type of help must be linked to solid, verifiable progress towards consolidation. At the same time, indebted countries must do everything to implement painful reforms and become competitive.

If we want to start a new phase of European integration, we will have to give the European project back its heart and soul. Technocracy will not be enough. The European Union is more than just a construction site or a repair shop, and our words should reflect that—otherwise people will turn their backs on Europe. What we need to do now is use what we have already achieved to rally support and continue fighting to maintain it. We need to ask ourselves the fundamental question of whether more national sovereignty rights can and should be transferred to European institutions. This is something that must be decided by the people of Europe; legitimation needs a broader base, even if this results in Europe becoming slightly smaller.

The sovereign debt crisis shows that existing treaties and institutions are not enough. We desperately need to implement an enhanced framework that incentivizes sound public finances. The cleanup of public budgets will be the critical test for European democracies and the fate of the European Union. History does not give a clear answer on whether democracies are capable of going through with unpopular measures like sustained debt reduction over the long term. The wealthiest generation in history must now provide proof that it is able to do just that.

It may be a bitter pill to swallow, but Germany simply cannot assume liability for countries that are not able or willing to walk this road with us. Such countries may need to leave the eurozone. Even Germany is limited in terms of how much political and fiscal liability it can shoulder. Germany cannot endanger its commitment to Europe by promising more than it can deliver. ◆