DEBT CRISIS IN THE EUROPEAN UNION

Introductory thoughts on topical issues

Looking back at the past, no other decade has been devastated so much by economic crises as the one that recently ended. It all started with the bursting of the New Economy bubble at the turn of the millennium and was followed by a catastrophe in the subprime bonds sector[1], which eventually led to the financial crisis of 2008, which in its turn caused a crisis in the banking sector and led to the current government debt and euro crisis. Over and over again, strong destructive lines of force originated in the financial markets. According to the studies by V. Cerra and S. C. Saxena,[2] failures in real economy accompanied by hurricanes in the financial sector are extremely lasting and hard to alleviate, particularly in the developed industrial countries. Therefore the effectiveness of the economic systems of the Western countries is increasingly regarded as questionable by an increasing part of the society – including economists – in public discussions. The theory of self-regulating forces of the free market, compared by ’an invisible hand’ by Adam Smith who laid the cornerstone for the whole theory, has proved to be a mistake in the economic history. Market economy with which it was hoped to achieve general order, balance and stability, has proved to be an extremely imperfect system in reality. In other words: market economy is a system of imbalance by its nature. We have to admit according the well-known quote of Winston Churchill, however: The market is the worst system of economic and social development – except for all the others that have been tried from time to time. There is no alternative more reasonable than the market but it is absolutely necessary to know the limits of the market in order to start fighting against wrong developments in time.

Already before the global financial crisis the high debt burden of numerous countries made people wonder. Public expenditures in billions to rescue banks that are essential for the functioning of the system and to support the economic cycle have allowed government debts to increase to critical limits so that chain reactions of government bankruptcies are dreaded in financial markets. The debt burden of the OECD (Organisation for Economic Co-operation and Development) countries reached already 73% of their GDP in 2007 and will probably increase even more this year and will exceed the limit of 100%. The U.S. economists Kenneth S. ("Kenn") Rogoff and Carmen M. Reinhard state in their analyses[3] that already 90% will exceed the limit starting from which government debt may start paralyzing the economic growth.

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[1] The U.S. real estate crisis caused by wrong evaluation of real estate bonds by U.S. banks for many years and which eventually involved also international banks.
[2] Cerra, V.,Saxena, S. C. Growth. Dynamics: The Myth of Economic Recovery, IMF Working Paper, 07.08.2005.
[3] Rogoff, K. S., Reinhard, C. M. Growth in a Time of Debt, American Economic Review, May 2010, pp. 573 – 578; hereinafter: the same, Dieses Mal ist alles anders, FinanzBuch Verlag, Kulmbach, 2010.

A large government debt restricts the political scope of action. The higher are the interest payments arising from the debt, the less funds can be directed to such areas important for growth as education and infrastructure, without taking into account here the implementation of any anti-cyclic programmes during recession periods. Therefore consolidation of state finances should be regarded as the first priority in the next few years. Considering the size of current government debts, probably only a few countries will be able to reduce their debt burden considerably in the near future. However, reduction of the level of government debt, i.e. the proportion of debt to the economic performance of a particular state, i.e. its GDP, is of critical importance. By increasing revenues and cutting expenditures it is possible to avoid new borrowing. Stronger economic growth, on the other hand, increases the GDP and therefore also reduces the debt level with respect to GDP. The division of focus among these three basic starting points depends to a large extent on the taxation system, structure of expenditures and resources of growth and eventually also on the political framework.

Increasing the government revenues – bearing in mind above all taxes here – is particularly related to the problems of distribution. Here politicians focus above all on indirect taxes as these will recede to the background soon in the minds of most taxpayers after a relatively short period of getting used to them, and will have a minimal effect on demand by consumers. In that sense, the more favourable impact of indirect taxes on economic growth is more evident than in the case of direct taxes which reduce the profits of businesses permanently[4] and are therefore a reason for changing the location of an enterprise.

While direct progressive taxes are politically attractive, they are risky from economic aspects. On the other hand, a negative aspect of indirect taxes is their extremely regressive effect on redistribution. The excise tax on tobacco, alcohol and other addictive substances is an exception here as their relation to human health is considered above all. Besides raising taxes there is also the option of changing the ownership form of state-owned enterprises and privatising them. Such a step can really be considered as it would not impair the fulfilment of state functions that would be a disadvantage to the general public.

However, it will not be possible to solve the debt problems by only increasing revenues. The states will also have to cut their expenditures. This is a source of particular problems as social expenditures take up the largest share of state budgets. Therefore saving costs in this field will be unavoidable, no matter how hard it would be, considering the apparently justified property status cast in stone of quite a few social strata. The minimum task should be to make cuts in areas where the intended aims of the redistribution policy are exaggerated and have led to an imbalanced situation, such as at higher government posts, including parliaments and governments. Payment of social benefits (e.g. child benefit) should be stopped if the income exceeds a certain limit, and this limit should be flexible. It should also be analysed to what extent the bureaucracy that has expanded in the course of time

[4] If there is no possibility for passing the tax increase burden on to others, i.e. clients

could be reduced to a reasonable volume. There is a savings potential above all in the field of arms industry. We have to admit, however, that the policy of strict economy applied to countries in crisis alone will not relieve the debt problems. If a policy of economy which is even oriented to austerity is not well-considered, it will rather make the problems more acute as there is a risk of deceleration of economic growth and increase in employment as a consequence.

Besides deficits of state budgets also deficits of the balance of payments on current account should be critically analysed for certain EU Member States. Negative balances of payments on current accounts essentially mean that more services and goods are used in the national economy of these countries than they are able to produce themselves and they have to borrow from abroad to that extent. If the larger quantity of goods and services financed with loans is used for the creation and development of competitive domestic industry, it is quite welcome as this lays the basis for future economic growth. But if these are goods which only serve the interests of consumption by the local population, such countries are living beyond their means. This makes such countries more susceptible to crisis and they will have to undergo painful adjustment processes sooner or later. Then it will often not be possible to distinguish between private and public debt when the private obligations of important debtors essential for the functioning of the system become government debt through the system of bailouts.

Economic growth is the third starting point for the reduction of the level of government debt. This assumes carrying out fundamental structural reforms to overcome the lack of competition in Europe and keep the international competitiveness of the EU on the sustainable level.

This specifically means the development of infrastructure and promotion of education, above all the promotion of studying such subjects as mathematics, computer science, natural sciences and technology as the economic sectors oriented to scientific research and technology have a particular role. Although it requires an increase in government expenditure and tends to increase the government debt, this is compensated by even faster growth of GDP in the case of policy which favours successful economic growth, and therefore the debt level will even decrease as a consequence.

The future of European will not only depend on the development of financial markets[5] – also labour markets have a critical role. Problems caused by debts can only be solved if the dramatic increase in unemployment in most EU countries can be alleviated. This concerns particularly the alarming increase in unemployment of young people. Young people are the future of Europe and its fundamental growth potential. Concepts with well-considered objectives should be developed for the provision of education and qualification to them in order to make use of the potential

[5] Cf here: Eesti majanduspoliitilised väitlused - 18/ Estnische Gespräche über Wirtschaftspolitik - 18/ Discussions on Estonian Economic Policy - 18. Berlin, Tallinn: BWV, Mattimar, 2010, p. 9.

described. Otherwise, chances of critical importance are lost. The statement of the German Chancellor Angela Merkel about Europe – „If the euro zone breaks apart, so will the European Union", should be more specifically restated as follows: If Europe forgets its young people, also the idea of Europe will fade away.

The fiscal union and its bailout funds should be considered an important precondition for the solution of the topical problems of the EU during the transition period. But only this will not be enough. It has to be supplemented by the economic growth agenda and the flexible labour market policy which focuses above all on the reduction of unemployment among young people.[6] Studying languages in Member States, unbureaucreatic recognition of professional qualifications in all fields, harmonisation of professional qualification programmes and also intermediation and exchange programmes within Europe should be promoted.

The Member States which are fighting with debts and are charged high interest rates during to their low ratings like the idea of eurobonds very much, sometimes even demand them. This is quite understandable. While before the transition to euro the movement of capital was directed by the developments in exchange rates which take into account risks, only deviations in interest rates have an effect on these in the current eurozone. If we introduce eurobonds, government debts[7] will have a common interest rate depending on the average creditworthiness of the eurozone countries. There would be no function that would discipline financial markets and would be manifested by differences in interest rates according to the creditworthiness of the debtor. As a result, countries in crisis would have to pay much lower interest rates. It will not be certain whether any funds left from servicing the loan would indeed be used for measures stimulating economic growth. There is no longer such pressure for the implementation of measures that are unpopular anyway in order to consolidate the state budget. Eurobonds would relieve the countries which are suffering from a high debt burden from their obligation to follow the budgetary discipline and would actually leave their past sins to everybody to bear. Countries with considerably lower debt levels would have to pay higher than average interest rates, however. This invalidates the causer principle according to which any costs incurred due to an action or omission should be born by those who caused them. Unsolid budgetary policy would no longer be punished by requiring higher interest rates.

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[6] Cf here: Clement, W. (former Minister of Economics and Labour of the Federal Republic of Germany), Ohne die Jugend ist Europa verloren, Handelsblatt – Deutschlands Wirtschafts- und Finanzzeitung, 10.-11.02.2012, p.10.
[7] This applies at last to the so-called *Blue Bonds*.