EUROPEAN POLICY CENTRE

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Commentary

Beyond austerity

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The euro zone is back in crisis. The situation has remained precarious in Greece, with a higher than expected deficit. Spain and Portugal are both suffering from continuously high interest rate spreads, paying a higher rate to finance their public debt than the stronger economies enjoy, such as Germany.

The immediate problem has emerged in Ireland, where the crisis cruelly exposed both its property bubble and over reliance of its banking sector on the property market, with the financial sector having grown out of proportion to the rest of the Irish economy.

The Irish people now are paying the price for the state guarantees for the banking sector which were put in place when the whole sector was on the brink. The Irish government's initial reluctance to accept support from the rest of Europe and the IMF crumbled as the sheer scale of the failed banking sector became too much to handle, coming on top of the impact of a deep recession. The Irish deficit is projected to come in at around one third of GDP, rapidly pushing Irish public debt towards the group of the most indebted countries in the EU.

Ireland's fall from grace has been remarkable - from the euro zone's star performer to one of its problems in a couple of years. It now joins Greece as a country which not only had to receive support but also has to accept a set of stringent budgetary conditions. Ireland's Government is currently attempting to push through another austerity budget that encompasses the conditions set by the rescue package, coming on top of previous austerity measures. Already, the political costs of the deal seem clear with the Government set to resign after the austerity budget is passed.

The troubles in the euro zone are likely to continue. Portugal and Spain are increasingly coming under fire from the markets. Economic conditions differ, and arguably speculation is driving much of the current increase in spreads, but it looks likely that more action will be needed to shore up Europe's weakest economies, with increasing political misgivings about the continuous need for bail-outs in the stronger economies, especially Germany.

But even if further speculation and crisis can be prevented for now, it will not be enough to solve the long term problem: increasing economic divergence in the euro zone. But can Europe's weaker economies - Portugal, Ireland, Greece, Italy and Spain - come back from the brink? The key lies in the need to encourage economic growth, moving beyond the single-minded focus on fiscal discipline.

Without a healthy growth performance in Europe's weakest economies, the attempts at achieving fiscal discipline are doomed, no matter how hard the countries themselves try. Austerity will not work if a weak economic situation erodes tax revenues and increases public spending pressures. The overall debt burden becomes heavier with a shrinking GDP.

This is not to say that European governments should continue trying to spend their way out of trouble. Fiscal sustainability is necessary as the current situation is no longer tenable - not least because markets will not accept a half-hearted attempt. But at the same time, investments for the future and reforms to strengthen competitiveness will need to be prioritised.

This investment is not going to come from inside these countries alone - the rest of Europe will have to get involved. Economic governance at EU level has to integrate policies aimed at monetary stability with policies such as Europe 2020 to drive long-term growth - in effect realising the growth element of the Stability and Growth Pact.

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This has to be underpinned by an ambitious programme of policy instruments, designed to deliver the vision. The EU can make a start, not least by adjusting its budget and main spending lines or by creating the conditions for business growth, for example through the full completion of the Single Market. EU project bonds can help to encourage investment in infrastructure and in the modernisation of the weaker economies. But Europe's richer economies will also have to offer support.

The countries receiving support will, of course, have to do their part, for example reforming administrative and tax systems and removing market restrictions. But the biggest problem lies in the willingness of the economically-stronger Member States to invest in the economic future of weaker ones. Unfortunately, the opposite seems to be the case: countries such as Germany will not even contemplate that solving Ireland's and Greece's long-term problems will require additional investment, over and above the crisis funds which have been made available.

This is short-sighted: a more balanced economic development in the euro zone will also benefit the stronger countries in the long term. A better functioning European labour market can, for example, help Germany to meet its skills' needs in the face of demographic change. More growth in the peripheral countries will also increase intra-EU trade and business investment. In a global world, it would help the EU as a whole to compete with the emerging economies. And, last but not least, it might prevent future crisis and the need for yet more crisis money. But we will need leadership: Europe's leaders will have to explain to their citizens why support is not only necessary but will, in the long run, prove beneficial for all concerned.

The alternative scenario is dire: the pain experienced by citizens in the weaker economies will not be compensated by a brighter future. How much longer will they then be willing to accept the stringent measures? There will be increasing divergence in the euro zone, re-emerging crisis and the need for intervention - and a real risk for fragmentation.

But the stronger economies will also suffer - directly, through the public purse or their financial sectors, and indirectly, through the loss of economic potential. Even the unthinkable might happen: the disintegration of the euro-zone with severe economic and political implications for all EU Member States. In the long run, all parts of Europe must prosper if we do not want to risk European disintegration. This is not a question of welfare or solidarity for the weakest EU economies: it is the only path to a common and positive economic future for all Europeans which is sustainable in the long run.

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