# Sabine Lautenschläger: The European sovereign debt crisis and its implications for the younger generation

Speech by Ms Sabine Lautenschläger Deputy President of the Deutsche Bundesbank, at the Junger Wirtschaftstag of the CDU. Frankfurt am Main, 26 October 2013.

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## 1. Introduction

Ladies and gentlemen

I am delighted to speak today, at the Junger Wirtschaftstag of the CDU, about a topic which I believe has not yet been adequately discussed in the chosen context, namely: what the European sovereign debt crisis means for the younger generation. Not only should this question in particular be placed at the heart of many debates about the financial and sovereign debt crisis – the envisaged solutions, too, need to be measured in terms of their implications for young people. After all, they are the ones who will have to shoulder the burden if we delay resolving the crisis from the present to the future.

Allow me to begin my thoughts on the sovereign debt crisis and on its implications for the younger generation with the following quotation.

"The progress of the enormous debts which at present oppress, and will in the long-run probably ruin, all the great nations of Europe, has been pretty uniform."

If anyone here believes this to be an especially bleak description of the situation brought about by the European sovereign debt crisis that has persisted for more than three-and-a-half years now, he or she is mistaken by 237 years. This quotation is not a recent one – it dates from the year 1766 and is taken from the most important piece of work by the famous Scottish economist Adam Smith, who is considered the founder of classical economics. And yet today, much more than 200 years later, the transmission mechanisms of a sovereign debt crisis have seen very little change. Yet to be precise, when considering the present-day situation in the euro area, we should really speak of crises in the plural, since what we experienced was the mutual reinforcement of a banking and a sovereign debt crisis. And only if we carefully analyse the causes and consequences of the crisis can we learn from past mistakes and find solutions. Thus I would like to examine, briefly, the three main reasons for the crisis.

1. Unsound developments that were home-grown persisted unchecked for years in individual euro-area member countries. The competitiveness of the present-day problem countries became eroded as a result, and the state of public finances deteriorated.
2. Major flaws became visible in the framework of monetary union.
3. Nor did the situation in the financial system or in financial market regulation look any better.

The crisis still has the euro area in its grip, although first signs are becoming apparent of an improvement in some member states.

The younger generation was, and still is, the hardest hit – on two accounts.

- Many young people in the crisis-hit countries are currently experiencing great difficulty finding jobs, as youth unemployment is disturbingly high in many countries.
- But the sovereign debt crisis, too, casts a shadow over our young people's future, as the last few years have seen sovereign debt rise dramatically throughout Europe.

These debts will have to be shouldered by the younger generation in the future, and the interest burden and redemption payments will narrow fiscal policy leeway substantially.

Clearly, then, the causes of the crisis need to be eliminated once and for all in the interests, not least, of the younger generation. Only then can we can be sure not to impose an excessive burden on young people, for whom we should actually be creating sound foundations for economic growth and prosperity.

Against this backdrop, I see three areas which are in need of reform, and which I would now like to examine in more detail. These are the labour market, public finances and the institutional framework for monetary union.

## 2. The need for reform in the labour market

Let me turn first, then, to the labour markets as we currently find them in a number of crisis-hit countries. In the years before the crisis, those countries slowly but surely suffered a loss of price competitiveness. This development was of their own making, because for many years wages rose at a much faster rate than productivity, driving unit labour costs up sharply as a result.

However, the hazardous nature of this development was recognised very late – too late, as it turned out. In the years that followed the introduction of the euro, the crisis-hit countries at first experienced vibrant economic growth. In fact, in many of today's problem countries, the booming economy masked the fact that their competitiveness was waning.

By contrast, ten years ago, Germany was referred to as the "sick man of Europe", and there were good reasons for that *sobriquet*. Particularly between 2001 and 2005, German growth was weaker than that of just about any other euro-area country. In our economic policy staff paper entitled *Ways out of the crisis* and published in 2003, we, the Bundesbank, wrote: "Germany has fallen far behind European partner countries in terms of key data such as GDP growth, employment and the government deficit." Far-reaching reforms were initiated in Germany to tackle this period of structural weakness. These included the Agenda 2010 reform programme, which was controversial at the time and included the so-called "Hartz IV" legislation. This was accompanied by a ten-year period of wage moderation running from 1997 to 2007, which addressed the location-related problems that faced key industries and the high level of entrenched unemployment at that time.

The situation on the German labour market has improved considerably in the meantime thanks to the reforms that were introduced back then as well as to wage moderation.

- The number of persons in work has risen by 3 million since 2005 and now stands at an all-time high.
- The number of registered unemployed has fallen from almost 5 million in 2005 to less than 3 million today.
- And the average duration of unemployment has receded sharply.

Germany has gained considerably in competitiveness over the past 10 years, for which reason it is now often seen as a model for reforms in the crisis-hit countries. Nevertheless, I do not wish to recommend Germany's reform agenda as a "template" for other countries to apply directly and uncritically to their own situation.

After all, the starting situation differs from one country to the next. Tailored, country-specific solutions need to be found for each individual country's problems. And yet, some general recommendations for the crisis-bound countries may certainly be gleaned from Germany's experience with reforms.

Some countries will ask how the unit labour costs that rose excessively in the countries that were later hit by the crisis might be cut – and where this has already happened. How can they avoid repeating past mistakes in the form of excessive wage and salary increases in future? Because that is the only way to restore and maintain price competitiveness.

What is more, in some countries rigid labour markets are in need of reform. In particular, the disturbingly high level of youth unemployment in the crisis-hit countries shows the urgent necessity of reforms in this area. Without reform, young people will be denied the prospects they desperately need after obtaining their school or university qualifications. We must make it easier for them to enter the labour market.

The longer it takes them to make the transition from school or university to the labour market, the more difficult the transition becomes. Policy makers in Europe have launched the Youth Guarantee scheme, a kind of promise of employment, to combat the youth unemployment problem.

Measures of this kind may afford short-term relief, but they will not create jobs that are profitable on a long-term basis. The sobering truth is that the high level of youth unemployment in the crisis-hit countries can only be checked by radical reforms. Looking into the past we see that ten years ago, for example, youth unemployment in many southern European countries was higher than their overall unemployment level. By contrast, in Germany at that time – when the country was caught up in a phase of weak growth and serious structural problems – the exact opposite was true. In 2003, when Germany was known as the sick man of Europe, German youth unemployment was lower than general level of unemployment in Germany. This fact in particular illustrates that youth unemployment has a lot to do with structural causes, but very little to do with cyclical influences.

What exactly is meant by structural causes? Where do the biggest problems lie?

The three most important problem areas for the southern European labour markets may be outlined as follows.

1. The labour markets are strongly segmented, and give established, older employees high job protection.

What is undoubtedly an advantage for them, however, proves to be a major obstacle for young people in search of a permanent position. Consequently, young job-seekers are often only offered temporary employment contracts which are easy to terminate when economic activity slackens.

2. Legal or negotiated minimum or entry-level wages for young workers are often relatively high in those countries. This can be an obstacle to employment. In Germany, by contrast, it is customary for apprentices to receive a distinctly lower starting wage.

3. In many of the crisis-hit countries, vocational training is mainly school-based and is often not sufficiently geared to enterprises' needs in terms of labour and qualifications. In countries with dual training systems such as Austria, Switzerland and Germany, on the other hand, youth unemployment is very low by international standards.

While there is therefore a lot to be said for a dual training system, the countries concerned cannot, of course, change their system overnight. For this reason, measures to introduce a new training system would only improve the job prospects for young people in the longer term.

But what about Germany? What needs to be done here?

I will begin with the most obvious point. We should welcome young, well-trained job-seekers from crisis-hit countries with open arms. The result would be a win-win situation. People from the crisis-hit countries would find jobs here, and may possibly one day return to their home countries with the knowledge and experience they have acquired here. And employers in Germany would find the right employees for the posts they want to fill.

But, in Germany as elsewhere, there is more to do than that: we in Germany need to continue to tackle the ongoing challenges of globalisation, and we also need to do more to deal with the challenges of demographic change. We, like others, cannot sit idly by.

Therefore, this is no time for resting on our laurels. We also have to continue to think about how we can ensure that our enterprises can find sufficient numbers of skilled, motivated employees, given that Germany's potential labour force is steadily shrinking for demographic reasons.

- First, then, we should try to increase labour force participation amongst women and older people …
- … and, second, we should make it easier for skilled workers to migrate to Germany.

However, it is not just a matter of slowing the shrinkage of the labour force – what are also required are measures to enhance labour productivity. Here I am thinking, in particular, of expenditure on education. But it is less about the level of spending on education, and more about the targeted use of resources, particularly in the provision of pre-school support.

Another important challenge is in integrating the low-skilled and the long-term unemployed into the world of work.Looking ahead, there will also have to be a discussion about how the German economy can be better equipped to deal with *ongoing* structural shifts. If we are to hold our own in the international competitive environment, we will need to enable workers from shrinking industries to migrate as smoothly as possible to new growth industries. That requires a labour market which is not just flexible on the edges. Now I have looked at the need for reform in the labour market, I must, of course, turn to the issue of public finances.

## 3. The need for reform in public finances

As a result of the financial crisis and the ensuing economic collapse, the budget deficits of many euro-area countries expanded significantly. In 2010, the deficit was above the threshold of 3% of gross domestic product in 14 out of the 17 countries.

Indeed, in Ireland action to rescue the domestic banking system pushed the deficit up to just under 31% of GDP in 2010. The concomitant increase in the debt ratio and doubts about debt sustainability led the capital markets to demand very high interest rates in return for financing Greece, Ireland and Portugal.

These countries decided to request assistance from the other euro-area countries – though, of course, subject to strict austerity conditions. What is sometimes felt to be an imposition in the countries concerned is ultimately in the interests of the crisis-hit countries themselves.

After all, putting off the necessary consolidation affects the younger generation. For instance, this generation would have to pay higher taxes to service government debts.

Even if John F Kennedy rightly pointed out that it is the fate of every generation to live in a world under conditions it did not create, this should in fact be an incentive to create the best conditions possible for the next generation.That includes, for instance, sound public finances – as well as healthy economic structures, of course. For this reason, the work of reducing budget deficits and public debt needs to be done now.

Thus, the more stringent European fiscal rules and national requirements such as the German debt brake are a step in the right direction. However, they will only be useful, of course, if they are actually adhered to and do not just exist on paper. I am not unaware of the criticism often levelled at what is perceived as "austerity dogma", and the frequently expressed fears of slash-and-burn spending cuts leading to recession. In my view, there is no alternative to sustained consolidation in public finances. "Business as usual" in fiscal policy would sow doubts on the financial markets about the sustainability of public finances in some of the crisis-hit countries, and thereby only exacerbate the crisis in confidence. Consolidation and growth are not mutually exclusive in the medium term – in fact, they are mutually dependent. Just as stronger growth will benefit public finances, so sustained solid growth is impossible without sound government finances. Having briefly set out why fiscal consolidation and structural reform are, in my view, the only way to go, let me make a few comments about the institutional framework of the euro area.

## 4. The need for reform in the institutional framework

The crisis has shaken the euro area to its core and the institutional structure of the monetary union has developed cracks. These weak spots need to be rectified. It is crucial that the repairs are not just cosmetic.

The monetary union needs to stand on a firm foundation if it is to be stable in the long term and flourish. Of central importance to this is that appropriate account be taken of the incentive system underlying all human behaviour: those who bear responsibility must answer for it. Economists and lawyers call this the principle of liability.

In other words: the right relationship between control of the decisions made and the concomitant liability for the consequences thereof is not only a constituent element of any market economy.

It is also essential to the structural design of the European monetary union. In sum, it is about those who enjoy the benefits also bearing the costs. A simple principle, but one which is the basis for prudent and responsible individual behaviour.

Freedom of choice and liability belong together as a conceptual pair; they are two sides of the same coin. The relationship between control and liability in the monetary union has got out of kilter. With the crisis measures over the past three-and-a-half years, the shared liability of all member states for unhealthy fiscal and economic policy developments in individual member states has been expanded.

Despite increasingly mutualised liability, however, the scope for mutualised control has not been expanded to the same extent. In order to restore the balance between control and liability, there are two basic options available.

- Either we take the step towards deeper fiscal integration, or …
- … we further develop the existing institutional framework and strengthen individual countries' responsibility for themselves.

However, a deeper fiscal union must not simply mean extending mutualised liability. This would be a transfer union, without mutualised control, and would not have the requisite disciplinary effect on the individual countries.

Instead, taking the creation of a deeper union seriously implies that the member states would transfer national sovereignty to community level; this should apply at least if individual countries request assistance from the community.

In concrete terms, this means, for instance, that the community would acquire the right to make the necessary interventions. However, a transfer of authority of this kind would require amendments both to national constitutions and to the EU Treaty.

I do not currently see any broad political support for this in the member states. As long as there is no willingness for a far-reaching cession of sovereignty in fiscal matters, then the principle of individual national responsibility enshrined in the Maastricht framework must be strengthened.

The fiscal compact, which was beefed up last year, is to be welcomed in this respect. Now it is a question of implementing the more stringent rules and ensuring they are adhered to.

It is the task of the European Commission to keep an effective watch on compliance with the rules.

However, it is not only the new fiscal rules which aim to bolster the principle of individual responsibility – this is also part and parcel of the major institutional project going by the name of European banking union. For me, banking union entails a single European banking supervisory mechanism and a single European recovery and resolution mechanism. I regard the notion of a single deposit guarantee scheme as premature at best. Banking union, too, is a step in the right direction for me. And here, as elsewhere, it is now a matter of putting the plan into practice. If designed properly, the banking union will lend considerable added strength to supervision and make it more efficient; and it will help to make it easier to wind up banks.

If a bank insolvency should prove unavoidable – and no supervisor in the world should be trying to ensure no bank ever exits the marketplace – then the purpose of the European recovery and resolution mechanism is to enable the bank to be wound up without significant danger to financial stability.In a “European resolution” scenario like this, banks’ owners and creditors are to bear a sufficient share of the losses. European taxpayers must no longer be the first line of defence – they should be the last resort.

## 5. Conclusion

The crisis has placed a considerable burden on the population, particularly in the crisis-hit countries. This has affected the younger generation in particular. Far-reaching reforms are essential if the crisis is to be overcome in a lasting fashion.

- The reforms must start with the labour markets in particular. There are signs of initial success, but the pace of reform must not drop off.
- In addition, governments must clean up their finances.
- Finally, the institutional framework of the monetary union needs to be strengthened in order to enable it to cope better with future crises.

Admittedly, none of this is an easy task which can be completed in a short space of time. The problems have built up over many years, and the path of reform before us is therefore correspondingly long and stony. The work by Adam Smith which I quoted from at the beginning of my speech is called *The Wealth of Nations*. To ensure that European monetary integration can give a lasting step-up to the wealth of Europe, what is needed is a monetary union which is also a stability union. The Bundesbank is doing all it can to achieve this – in the interests of all, including the younger generation.