

EVENT REPORT

Böll Lunch Debates

Reconnecting Europe V

Are Things Getting Better in the Eurozone? ¹

The Come-Back of Portugal; Greece's Attempt to Stand on its own Feet again; Macron's Reform Proposals and Germany's Lukewarm Response

*In **Portugal**, the centre-left Socialist minority government, with the support of the Communist party and Left Bloc, has succeeded in bringing the country's budget deficit to its lowest level in more than two decades. When the government came to power in 2015, some northern eurozone governments and eurozone experts warned that its announced anti-austerity policies would lead to renewed financial problems. After all, Portugal needed a €78bn bailout in 2011, after recording a deficit of more than 11% the previous year. Instead, Portugal returned to investment grade debt status in September 2017. The government raised (minimum) wages, cut taxes, is restoring state sector salaries; choosing for drastic cuts in public investment instead. The economy is (modestly) growing and unemployment has dropped considerably. Portugal demonstrated convincingly that there is an alternative to following a strict austerity agenda. In the meantime, **Greece** is struggling to stand on its own feet again after eight years. Although the worst seems to be over, the country's finances still need serious repairing after an unprecedented economic meltdown. Even though the economy is showing signs of a slight recovery with modest growth, low inflation and a modest drop in unemployment, many issues are still pending and exiting the rescue programme in August might be premature. Also, in the meantime, French president Emanuel **Macron's** first attempt to present his ideas for eurozone reform, which include an own budget for the eurozone and an EU finance minister, on the EU March summit failed, mainly because of a lack of interest on the side of the **new German government**. All hope is now set on the June summit, but so far, the German response has been lukewarm; the Netherlands and eight northern states have already voiced fierce opposition against Macron's plans to transfer further powers to the EU. Will the north side against the south (again), widening the already existing north south divide in the eurozone even more? Has the south found a new ally in Macron whose statement that 'responsibility and solidarity of the eurozone have to be redefined', has outlined his reform principles – and will the French president succeed in persuading the Germans?*

¹ The event took place on the 25 April 2018. The panelists were **Diogo Martins** (Lisbon School of Economics & Management), **Eleni Panagiotarea** (Hellenic Foundation for European and Foreign Policy, Athens), **Ana Gomes** (MEP – Partido Socialista, Portugal) and **Gerhard Schick** (Member of the German Parliament – Bündnis 90/Die Grünen, Germany). The debate was moderated by **Klaus Linsenmeier** (Director Heinrich-Böll-Stiftung European Union, Brussels).

The eurozone crisis is not only a failure of the international and the European banking system; it is questioning the liberal financial market and neoliberalism in its nature according to many observers. The market was not able to overcome the crisis without public spending and the deficit has led multiple European states to the brink of monetary collapse and to severe pressure on the private and public sector resulting in a rise of unemployment and desperation among the crisis states' population. Subsequently, the hard austerity rules have driven a wedge between the struggling and the paying states. Greece, Portugal, Spain, Cyprus and Ireland had to cut public spending massively to consolidate their public debt. Enormous restriction led to a divide of northern and southern eurozone member states, the erosion of traditional majorities and parties and a rise of populism not only in the crisis states but all over Europe.

The phoenix of the crisis – is the Portuguese turnaround a role model for others?

After years of pressure from restrictions and austerity policy, Portugal decided to go its own way and has drawn a lot of attention by being successful with the unorthodox measures so far. Not only has the country recovered from the crisis faster than other struggling economies and was able to present positive results as well as to lower the restrictions – Portugal also is the only crisis-shaken state that did not face a rise of Eurosceptic and right-wing populism. So how did the country succeed with its way and could the Portuguese example suit other countries affected by the eurozone crisis?

The downfall of Portuguese competitiveness within the crisis is to be seen in a bigger picture eventually starting with a regression from 2001 onwards that accumulated public deficit and that harshly worsened from 2008 onwards, reaching its peak with the inability to repay or refinance the government debt on its own and the application for bail-out in April 2011. This long-lasting decline in Portugal had multiple drivers. The strong euro hampered the Portuguese productive structure of low value goods through the high real exchange appreciation and in consequence weakened the private sector. Moreover, the EU's enlargement to the east in 2004 put pressure on the Portuguese wage structure and the entry of China to the WTO increased the competition for Portugal's traditional export goods. Furthermore, the incentives to invest in non-tradable goods accelerated the downfall by decreased real interest rates and real exchange rate appreciation. Given these drivers beforehand, the Portuguese debt crisis and the eurozone crisis can be classified as a sudden stop crisis - after arriving slowly the economic downfall accelerates its pace very quickly. The triggers in the Portuguese case were turbulences on the financial market and the fear that the Greek crisis could be contagious which went with a lack of trust of the lenders regarding the repayment ability of the debtor country. Arguably, the common denominator of the crisis countries is not the high public debt itself but the high external debt.

After applying for bail-out programmes in April 2011 to prevent an insolvency situation, Portugal received a cumulated €78.0 billion from the International Monetary Fund (IMF), the European Financial Stabilisation Mechanism (EFSM), and the European Financial Stability Facility (EFSF) being able to leave the programmes in 2014. The annual growth rate of GDP constantly raised since 2013/2014 and the GDP now is on its pre-crisis rate. Despite still being lower than in 2007, employment is growing since the absolute low in 2013. Furthermore, Portugal was able to raise

internal demand in private consumption and investments without a growing external deficit or public debt and is on a way of stabilisation close to a balanced budget. The left-wing government, an unpredicted coalition left of the centre, was able to rise minimum wages and pensions, recover the wages for public employees and address precarious work in the public sector. While sticking to the rules of financial management and austerity it returned income to the public and softened some retrenchment, giving hope back to households and investors which helped undermining populists and engineering growth revenue. Nevertheless, the arguably biggest driver for the economic recovery is the boom in tourism which strongly influenced overall investment and demand in the private sector. Also, the revenues from tourism helped keeping the external sector balanced. Nevertheless, the tourism boom also caused severe problems for the country – the housing prices, especially in the cities, raised massively making it challenging for young people and the large number of precarious workers to find housing in the big cities. Moreover, the share of precarious work grew since many new jobs in tourism and elsewhere are on minimum wage and with non-permanent contracts. Unemployed, underemployed and discouraged workers still account for 15.8%. Another consequence of the strict austerity is to be seen in the quality of public services in health, education and public transportation after a period of disinvestment during the crisis.

Given these concerns and with a public debt still over 100% of GDP the Portuguese economy is still prone to crisis – a crisis which is in menacing proximity given the current concerns about Italy and the future of Europe and the eurozone. The government plans to rise the primary surplus up to 4.5% of GDP to reduce the public debt but high cost redemption may not be possible in the current need of public spending. Therefore, a reform of the eurozone would still be highly appreciated in Portugal. A high common budget to address asymmetric shocks, a full banking union to share the burden of rescuing the banks highly integrated financial system and a reasonable degree of debt mutualisation to tackle the risk of another financial crisis are possible solutions being discussed. However, it might be argued that the problem of a eurozone reform is not the lack of ideas but the lack of political majorities for their implementation.

Greece – rescued but far from crisis-proof and sustainable

Greece was a special case right from the beginning of the crisis because of its harsh macroeconomic imbalances in terms of trade and fiscal imbalance, and a tremendous loss of competitiveness that no other country had to face. It received a huge financial envelop but also had to imply intense financial monitoring and was subject to a supervision of conditionality that no other country experienced. Furthermore, other than Portugal, Greece lacks a national consensus supported by all parties on deciding what needs to be done.

After years of bail-out programmes and strict austerity rules, Greece is theoretically at the end of the process after the successful conclusion of the ESM stability support programme on 20 August 2018. Nevertheless, Greece will be subject to enhanced surveillance for another period of six months. Also, like Portugal, Ireland and Cyprus, it will stay subject to post programme surveillance until 75% of debts are repaid. The country is obliged to an annual budget review and committed to ensure that its annual budget achieves a primary surplus of 3.5% of GDP over the medium-

term. In parallel, Greece is fully integrated into the European Semester framework of economic and social policy coordination. Greece has also committed to implement specific actions in the areas of fiscal and fiscal-structural policies, social welfare, financial stability, labour and product markets, privatisation and public administration. The European Stability Mechanism participates in the context of its Early Warning System as in all other instances of post-programme surveillance. The clean exit after the tremendous pressure of a precautionary credit line was in everybody's interest as it embodies a return to autonomy and economic decision making. European Commission and ESM will try to stay on a successful and sustainable path and all sides are keen to claim Greece as a success story.

Despite all criticism Greece has had considerable successes. Economic growth is back and rising, growing in all quarters of 2017 on an overall 1.4% of GDP that is expected to grow to 1.9% of GDP in 2019 so there is justified hope that the recovery is picking up. The country has delivered a primary surplus and a budget surplus, surpassing all expectations and issued bonds on three separate occasions. It stays committed to the reform agenda with expansive pension and tax reforms from 2019/20 on. Nevertheless, difficult challenges remain. Given the re-emerging of the crisis and the developments in Italy it is crucial to maintain the recovery and to arrive at a sustainable high growth rate. Growth predictions are constantly revised downwards and there is a fear of Greece dropping in a vicious circle of low growth and high debts and interest rates. Moreover, the country has not changed its economic model and still has a high consumption to GDP ratio alongside weak innovations and exports together with a weak private labour market. Greece must tackle the impaired assets in the banking system as the non-performing loans ratio is 43.1% of GDP and investment is very low. The growth investment has declined to negative and is on -7% of GDP. The root causes are weak private investments, a declining public spending and a very low external investment willingness. Furthermore, with the commitment of generating a surplus of 3.5% until 2022 Greece is forced to continue with high taxation and low public expenditure in health and education. For the remaining challenge of meaningful debt relief short-term measures are already in place and savings are around 5% of GDP being expected to reduce debts on 25% of GDP until approximately 2060. Additionally, visible medium-term measures must be found to undertake further debt relief to regain belief in the markets.

Since Germany is in favour of tying debt relief to conditionality, Greece is obliged to stay on a credible path of adjustment for growth and fiscal stability without accumulating further debt. Portugal and Ireland have shown a way to further conduct with a significant two years buffer that helped to build investor confidence and to relieve questions of threat. In contrast, the Greek buffer is around 20 billion €, which is unsure to be sustainable without further debt relief. However, this is not likely as the eurozone economy is becoming more sluggish and a tightening of monetary policy is foreseeable as the QE programme will end in 2018. On the other hand, the question of a liability union is raised. Germany and other paying states are believed to call for risk reduction before any further risk sharing is implemented. Nevertheless, the eurozone states are in very different circumstances in terms of growth, employment and real wage growth, so it arguably might help to shift the discussion towards the question of what unites them.

Quo vadis eurozone reform – can the eurozone develop resilience?

Therefore, the crucial question for the very heterogeneous eurozone is how to achieve solidarity without homogeneity and, of course, the big question remains, how to advocate this solidarity in Germany without creating the impression among citizens that their country acts as paymaster of the crisis. Here, it is important to point out that the recent years of austerity policy are understood in Germany as a success story of Wolfgang Schäuble and not of Mario Draghi. All countries have accepted the 3% of GDP deficit spending goal and many countries are finally on a good track – so after 9 years, there is no reason for the conservatives to re-evaluate the crisis management. In consequence, it is no surprise that the new German minister of finance Olaf Scholz, a social democrat, is not looking for big changes. He is even rowing back on the issue of integrating the ESM legal base into EU law and disappointingly pushed the fiscal back-stop for the single resolution fund further down the road until 2024. The agenda of reducing risk before sharing it is reasonable but just cutting investment is no advisable strategy. Despite the inner-German pressure to restrain from spending, the current situation in Cyprus and Italy gives a sense of urgency to the German debate and shows the need for a more resilient eurozone.

The governing coalition is a far cry from changing their mind. Yet, Germany is not alone in avoiding to confront the truth and wait for external pressure to make a move. It looks like France is currently the only European state to put reforming the eurozone and working on its own deficiencies on the national agenda. There is no political appetite amongst eurozone states to touch the money of the rich to lower their state deficits, so Germany is in a comfortable position. However, the country should adopt a long-term perspective and take the lead in reshaping the European debate also seeing that Germany is arguably profiting most of the eurozone. The actual state of eurozone recovery and the sustainability of the situation and of loan ratios will only become visible after the current upturn comes to an end. Shifting the debate towards a common investment plan could bring in a new element and end the stand-off of European states by solving the common problem of low public and private investment. A saleable compromise therefore would be to fund the new investment by tackling tax loop holes and tax avoidance, introducing taxes on financial transactions and digital companies or a carbon tax. The eurozone is in need of new and innovative measures which create solidarity instead of rivalry among European states, contribute to the recovery of national budgets and cut the ground away from right-wing populism.