Europe: The Current Situation and the Way Forward

A speech by Dr. Wolfgang Schäuble
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Thank you very much for giving me the opportunity to talk with you today. Let me get straight to the point.

Since the seventies expansive, debt-financed fiscal policies have been the rule not the exception in industrial societies. With moderate success. Growth rates declined nevertheless.

For more than two decades, economic policy in industrialized countries tried to mediate recessions and financial market crises by increasing the leverage of the public and private sector and multiplying the money supply.

To be fair, these policies were necessary to cope with the immediate crises, but they tend to sow the seeds for the next one. With increased financial globalization the risk of systemic crises accelerated and recovery costs rose steeply.

I am not only thinking of fiscal costs here, but problems like rising inequality, racial and religious tensions, straining the bonds that bind our societies.

Is there an alternative to these repetitive cycles of credit booms followed by busts? I think, there is: It is the model of moderate, but sustained growth – defined as steady, environmentally-friendly and inclusive growth.

“Moderate growth” points to the economic heart of the matter: the decline in productivity growth which is at the core of the decline in growth rates and wage growth in advanced countries.

Surprisingly, the beginning IT-revolution in the seventies coincided with a slowdown in productivity growth. This is so surprising that economists call this observation “Solow Paradox”. “Solow” because of the Nobel laureate, who was the first economic celebrity who pointed out this paradox. Unfortunately, he did not explain the paradox. So what is the explanation for decreasing productivity growth since the seventies?

Perhaps the “Solow Paradox” is explained by globalization? By the fact that large emerging countries were integrated into the world economy? As a result, a large reservoir of relatively low-skilled workers has been created. Between 1980 and 2010 the number of jobs grew by 1.1 billion. 900 million came from...
developing countries. These workers compete with workers in developed countries.

If labor is cheap and abundant, it makes little sense to invest in labor-saving and productivity-enhancing technologies. So advanced economies do not take full advantage of productivity gains via digitalization. So at least that argument goes. I do not find it particularly convincing.

Given that wages in Europe are higher and labor scarcer, productivity growth in Europe should be higher than in the United States. Which is not the case. Another explanation is that technological progress increases productivity only after a delay.

A third explanation is that the digital revolution is perhaps not as transformative as the industrial revolution. And especially not transformative enough to compensate for the effects of demographic change and high public debt. Could be.

But the explanation I find most convincing is that the exceptional rise in productivity during the industrial revolution was aided by three additional factors: It occurred because it was accompanied by the introduction of compulsory education, which raised the productivity of labor significantly.

Secondly, because it was accompanied by the abolition of serfdom, which gave workers the opportunity to look for more profitable occupations than agriculture.

And thirdly, because it was accompanied by the rule of law and well-functioning institutions protecting property rights and allowing people to reap the benefits of the work and ideas in the market.

Of course, an increase in productivity in a given sector always means a reduction in labor supply in the same sector: In 1900, around 40 percent of Americans worked in agriculture, and slightly more than 40 percent of the average household budget was spent on food.

Over the next century, automation reduced employment in agriculture to less than five percent and food costs fell dramatically. But at the time the excess supply of labor was relatively easily absorbed in new sectors of the economy. Which was relatively easy given the training, that is the higher productivity of the U.S. workforce.
But getting a proper education, well suited for today’s labor markets, is not as easy as it once was. Particularly, labor markets in advanced economies suffer from a lack of skilled workers.

A mismatch of skills demanded and supplied by labor markets in advanced economies explains high unemployment rates, particularly when wages tend to be sticky.

In Europe, it is not so much academics that are missing, but workers who have successfully completed a vigorous apprenticeship program, with a mix of craft-specific and technical training.

But the consequences of the increase in low skilled labor by developing countries and the decrease in productivity by developed countries is by no means only an European problem.  
[so auch Edmund Phelps in FT-Artikel, 02/03/2015]

On the contrary, it is at the root of the economic and social problems in the United States too, its recurring fiscal crises and growing inequality. It is no coincidence that the financial crisis started in the United States and its real-estate sector. US policymakers tried to promote home ownership of poorly skilled workers by having less stringent lending practices.

US policymakers attempted to maintain high levels of growth and compensate for low wage growth and rising levels of inequality by means of monetary policy and a higher leverage of the public and private sector.

Helping poorly skilled workers and their families is praiseworthy. But lax monetary and lending policies are no replacement for good social policies and education.

Sure, there are adverse incentives in European labor markets to find work quickly. Which we are correcting, by the way.

But despite all its faults, Europe’s system is not badly designed for achieving equality of opportunity and alleviating social inequity. It does this by providing for affordable education, universal health care, and the redistribution of income.

In Europe moderate and sustained growth implies structural reforms and the deleveraging of
public and private sectors.

Done right, structural reforms and fiscal consolidation are complements, not trade-offs.

In the medium term a smaller public sector and more flexible labor markets help trim expenditures and lift growth. And a quick implementation of reforms will strengthen consumer and investor confidence, cancelling out any short-term dip in consumption.

The talk of so called “European austerity” is not supported by facts, as Peter Jungen already pointed out at a recent conference of the Columbia Center on Global Economic Governance: The absolute level of debt in Europe is higher than before the crisis began. And the debt to GDP ratio in the Eurozone is higher than ever before.

The Bank for International Settlements thinks that the indebtedness of the private and public sector, including the high leverage of banks and households, as well as a lack of structural reforms, hinders sustainable growth – especially in Europe. I think they are right.

Moderate and sustained growth requires that we align our debt and deficit ratios with our growth ratios. And that we implement structural reforms to increase productivity. What does that mean?

By structural reforms to increase productivity I mean enhancing labor market flexibility, increasing labor productivity through greater investment in physical and human capital, raising the retirement age, thus reducing social spending, facilitating migration and women’s integration into the labor force.

And the fiscal policy guideline is that under normal economic circumstances the rate of public expenditure should not rise faster than the nominal growth rate.

The question for the Euro area is: Can we adhere to the rules which prescribe structural reforms and fiscal consolidation in the Euro area? I think we can. And we have to – because of the special conditions of European governance: here I mean the structure of the European Union and the currency union.

The members of the Euro-area have transferred their monetary sovereign rights making powers to the European Central Bank.
But still the member states dominate the fiscal and economic policy of the Euro-area. It is of utmost importance that such a construct of semi-sovereign states adheres to the rules they have given themselves to keep the common monetary and economic area intact.

In fact, European governments do just that since the beginning of the crisis. Sometimes more and sometimes less, but the direction is clear.

As a result, growth is returning and the competitiveness of the program countries Spain, Ireland, Portugal is increasing. Unit labor costs are lower. Current account deficits have declined markedly, at least partly due to successful exports. A decrease in unemployment rates is visible. Germany bolsters this process as Europe’s fiscal and economic anchor.

Of course, the situation of some member states of the Eurozone, notably Greece, remains serious. But European Monetary Union won’t succeed if a member country weakens its competitiveness and persistently runs large deficits to finance consumption. Such policies would be at the expense of the Euro area’s stability.

By supporting Greece and later on Ireland, Portugal and Spain, we prevented the collapse of international financial markets, perhaps avoiding another recession of the world economy. And we have given reform countries financial breathing space by means of low-interest-rate loans, while they in turn implement structural reforms.

This, in addition to institutional changes, first and foremost an European Banking Union, and a flexible but stronger fiscal framework for member states has been part of an overall concept to put us on track for moderate and sustained growth.

Overall, Europe’s policies are sound. By fits and starts, by trial and error, we will improve on these policies. This is how open societies should work. And this is how European societies do work.