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The Financial Crisis: What kind of Recovery is Possible?

The Economic and Financial Crisis by the European Union: Lessons to be learned Upheaval and Rescue

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Just a year ago observers were still declaring the euro to be one of the victors of the crisis. The Icelandic frenzy to join Europe and the euro after years of sarcasm about Brussels' bureaucracy and the Baltic countries' determination to undertake deflation policies to maintain a stable exchange rate with the euro seemed to confirm the success of the single currency. Whilst Europe suffered particularly badly during the recession at the end of 2008 and at the beginning of 2009, it had at least been able to avoid the mortal competitive devaluations which had amplified the damage incurred by protectionist policies in the 1930s. At present we have to somehow "climb down": the euro area is in complete turmoil and following the Greek misery of spring 2010, doubt about Irish public finances in autumn 2010 has caused the euro to plummet once more.

The most worrying element in the series of convulsions affecting the euro is not the badly dissimulated joy of Europe's adversaries. A hidden alliance has been made been between the eurosceptics, the British press led by the *Financial Times* and part of the American administration, which wants to be rid once and for all of the dollar's rival. The members of this alliance regularly blow the mort and are ever more impatient to see their secret wish of the collapse of the euro area, and why not of the Union, finally come true. More worrying is the fact that as the attacks against the euro follow one another, a kind of resignation seems to be taking hold of Europe's leaders. Increasingly the defence lacks conviction; unexpected voices are being raised to join the concert of eurosceptics to show that the ongoing monetary project will necessarily fail sooner or later. But as Angela Merkel said in November 2010 we should be aware that not only would the collapse of the euro area bring down the monetary edifice, but it would also probably lead to an overall setback in European integration, also threatening *acquis*, as intangible in appearance as competition policy.

It is therefore vital for the European Union to counter the onslaught against the euro. To do this we must take stock and learn from our mistakes and try to draw up specific answers that can solve the crisis. In my view there are *three* mistakes to avoid whilst the durability of the euro, and beyond that, of European integration, supposes two fundamental, thorough reforms. By mistakes I refer to certain aspects of economic theory such as the idea of an optimum currency area; the regular reference to poorly adapted economic policy tools such as devaluation; and concentration by Member countries on economic policy. The solutions lie in giving the total power of a central bank to the ECB and in a policy to harmonise European growth by improving competition.

European Integration and an Optimum Currency Area

The first flaw in the euro area which is systematically condemned is that it is not an optimum currency area. This criticism, however does not really make sense. The idea of an optimum currency area is like all of those in economic theory: it is a tool to understand reality, a means to improve economic policy but in no way should it be a Procrustean bed. The crisis has revealed the weaknesses in the way the euro has been set up – as notably seen in the difficulties in managing the accumulation of public and private debts – in Greece in the first instance and in Ireland and Spain in the second. It is therefore essential to seek solutions to the problems that have emerged. But it would be absurd not to react by saying that in any case nothing can done since the euro area is not an optimum currency area.

Another of the widespread and admitted absurdities is the idea that the zone's weakness lies in the Member countries' inability to devaluate. If there is a strict countable link between the external deficit and the public finances of a country via the development of its credits rating it, is simplistic to think that devaluation is the cure-all. Let's take Greece as an example: it is a country whose tax system is totally incompatible with economic development, and it is therefore difficult to see how devaluation would increase fiscal revenue. Indeed, how would devaluation reduce the Greek population's natural tendency not to fulfil its fiscal obligations? Likewise Iceland, which was swept up in a banking crisis similar to the one in Ireland, saw its currency collapse by nearly 80% against the euro without its general situation ever improving. The fall in purchasing power experienced in Iceland due to the increased cost of imports has gone well beyond that which austerity plans will mean for populations in countries in difficulty in the euro area or even in the United Kingdom. Devaluation is rather more a stratagem to mask the hard truth than an inevitable solution.

The third mistake in our analysis of the convergence of European economies would be to remain focused on simple aspects of economic policy, especially budgetary policy. Spain, which is now under fire, satisfied the criteria of the Stability and Growth Pact perfectly in terms of budgetary deficit and public debt prior to the crisis. However, its growth based on a surge in loans to fund an overestimated property sector was a vector for serious imbalance as revealed by the external deficit. This mistake continues to be made in the discourse on the need for budgetary federalism. It is quite clear that budgetary policy has to be implemented in Europe according to more or less homogenous rules – the most evident of these being the management of automatic stabilisers. If we make the increasingly strict control of Member States finances a central goal we shall however forget what is most important. A country's economic situation cannot be reduced down to that of its State. Moreover, no country can tell its population that a modern policy is based on greater decentralisation of decision making and at the same time say that Europe has to step up the centralisation of this process in terms of public finances. In fact, for economic convergence to occur in the euro area and beyond Europe there has to be convergence of output performance and an improvement in the mobility of productivity.

Enhancing the ECB, Improving Competition

Consequently, the two reforms which are vital– as revealed during the crisis- are the revision of the ECB's powers and the continuation of competition policy.

If there is no serious doubt about the USA's ability to reimburse its debt it is because the Federal Reserve is perceived as an unambiguous, ultimate lender. The same must apply to the ECB. Firstly, this supposes that it is totally independent of any national reference, i.e. that the national central banks have no power within it. It must not be the very first in a long list of monetary authorities, but the only, exclusive manager of monetary policy. This then supposes that its mandate is total and complete, like that of a central bank, which means financing growth but without allowing inflation get out of control. The view that is often advanced, whereby budgetary policy underpins the fight against unemployment, and monetary policy counters inflation –known by economists as the Tinbergen Principle- is now an outdated theory left behind by both instruments of economic policy currently in application. At present, budgetary policy has to regulate the economic cycle and monetary policy has to ensure the optimum funding of the economy. This means that the monetisation of the public debt, a means just like any other to inject liquidities, must not in any circumstance be removed from the tools which the ECB has at its disposal. For example, the Greek State has one single banker, the ECB - it is this bank and not the IMF that should reach agreement with it on defining the conditions governing its economic recovery, thereby allowing it to avoid a situation of sudden default being imposed upon it.

As for the convergence of the economies, this must correspond to a convergence in living standards and the well-being of the populations based on a permanent stimulation of production infrastructures by way of competition. When Europe backs down over the issues like the "Bolkestein Directive", it delays convergence more dramatically than when it allows a State to fall into debt. However, when the Spanish government made the labour market more flexible in order to improve growth, it was moving in the right direction. When Brussels looks into a directive to limit restrictions on working hours, Europe is converging. When Brussels dares to say that everyone should be able to retire in all the Member States at an age a person thinks fit according to the rights that have been accumulated, this new freedom will bring with it both growth and convergence. Instead of splitting hairs over the budget, we should choose to help the market breathe since it is and must remain one of the key elements of European integration. As it is considered polite to speak of the optimum currency area, the best means to draw close to this is to ease restrictions on the circulation of private capital and labour to the full.

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The euro is clearly in crisis, but there are technical means to solve this situation and rise above it. We will overcome the crisis if we all realise that doubting the euro – be it by predicting its disappearance or by calling for a redefinition of the euro area- is a catastrophe to the point that even European integration could be threatened. Silent unrest is starting to emerge however: in Germany some businessmen and politicians are talking of splitting the area into two. Questions are being asked everywhere about the legitimacy of obligatory solidarity which forces virtuous countries to pay for the financial excesses of countries that have no credit. At the beginning of December 2010 Jean-Claude Trichet made a "solemn" appeal for a "qualitative leap in the governance of the European Union". Let us hope his voice is heard! Let us hope that Europe will gain in objectivity and start true economic convergence, notably thanks to a constant increase in competition and greater mobility.