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Research Report

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Managing the Financial Crisis – Is Europe Getting It Right?

Heribert Dieter

The members of the European Union could use the current crisis as an opportunity to exert considerable influence over future restructuring of the financial markets. However, they can only do this if their crisis management transcends national boundaries. But since the crisis deepened in September 2008, no common, specifically “European” reaction could be observed. If European countries wish to improve the institutions of global governance, they must act together and provide a considerable demand side stimulation for the global economy.

The financial crisis and in particular the way in which it is managed is currently occupying governments around the world. They are employing a wide range of ever more extensive rescue packages and support measures. A few times over the past few months, it appeared as if the worst part was over, but new risks continued to materialise. In early 2009, the Bank of America as well as Citigroup surprised the world with losses requiring government assistance. In Europe, too, hardly a week passes without a fresh dose of bad news regarding the financial sector and increasingly the real economy.

This raises the question whether European governments are reacting appropriately to the crisis. For Europe, the crisis is a unique opportunity to promote a reform of international financial markets and

institutions of global governance since the Anglo-American model of financial markets has been discredited.

However, no efforts in this direction have been made to date; the opposite is the case: Europe has not presented itself as a model of good behaviour in a crisis. The problems started in early 2007 when European governments did not take sufficient note of the first hints of the crisis and failed to respond accordingly. As a result, one comparatively hastily designed programme now follows the next, conveying the impression of hectic and uninformed politics and hence exacerbating the crisis. In Europe in particular government policies have not been contributing to restoring confidence, but have occasionally contributed to the already emerging fears in their population. In particular, the con-

tinuous repetition of the inevitability of doom and gloom has dented the expectations of even the most ardent optimists.

Worse still, Europe has thus far failed to deliver a coordinated response to the challenge posed by the crisis. A common European proposal for reforming international financial policy is increasingly unlikely; nation states dominate the discussion. Thus Europeans are once more making way for other states, since no European country alone has sufficient influence in international politics. In addition, there is a danger that conflicting national responses to the crisis will harm the process of European integration.

Crisis Management: Britain, China and Japan are leading the way

The British Prime Minister Gordon Brown has turned out to be an extraordinary manager of the worst crisis that has hit the UK for decades. Two points are particularly important: Firstly, Brown used nationalisation as a policy instrument very early on, thus demonstrating that he did not regard voluntary solutions as sensible. He realised that private banks are trapped in a vicious cycle if they are not subject to pressure from the state: even if a bank lacks capital, it cannot ask for state help at the appropriate moment since this amounts to admitting that it cannot survive alone, prompting a loss of confidence on the part of customers and shareholders that might threaten its survival.

Secondly, Brown used a temporary cut of VAT to boost consumption, a measure with considerable psychological consequences: the prospect of tax savings on shopping can stimulate domestic demand. In doing this, the Prime Minister accepted that foreign companies benefited just as much from the cut as domestic ones, hence his management of the crisis has a much weaker national bias than that of other countries. Surprisingly enough, the British government has found a pro-European response to the crisis. Nevertheless, it is not clear that

British consumers – suffering from collapsing house prices – can be enticed to increase their consumption, tax cuts notwithstanding.

However, this is not intended to create the impression that British financial policy over the past few years has always considered the interests of European partners. Rather, the Blair and Brown governments have always opposed stricter regulation, not promoted it. The interests of the City dominated British politics; and this resistance to a European regulatory regime contributed to the current crisis. German and other European proposals to extend the regulation of financial markets usually failed because Britain opposed them. This experience with British financial policy might go some way towards explaining the German finance minister's recent harsh criticism of taking on high additional debt.

Of course this sharp critique by a German financial minister has caused huge fallout in the UK. This is partly due to historical experience: During the first years following German reunification, the then-powerful Bundesbank pursued a very tight monetary policy. The high interest rates were highly problematic for the UK which was in deep recession at the time. Finally, the pressures this created in the European Exchange Rate Mechanism (ERM) were released when Britain left the ERM on "Black Wednesday", the 16 September 1992, a rather traumatic experience for the country. There is still some bitterness in Britain today about the nationalist economic policy pursued by the Bundesbank in those days.

It is of course possible to claim that every economy should primarily look after itself in a crisis and not attempt to stimulate demand in other countries. However, in a globalised economy this argument is not particularly convincing. Rather, every country should support domestic demand as good as it can without being concerned about the potential benefits to foreign producers. The current crisis has not just hit one or a small number of economies,

but virtually every important economy in the world simultaneously.

However, it is necessary to differentiate according to ability. Some economies have benefited enormously from the willingness of others to buy their goods and services over the past years. This is evident from the huge current account surpluses they have racked up over the past decade. The surplus countries – mainly Germany, China and Japan – were dependent on those countries with deficits. It follows that the countries running a surplus in recent years have a particular responsibility to salvage the world economy: those who benefited from the debt of others in the past should now take the lead in rebalancing the system.

China and Japan are good examples regarding this. Both countries are spending large sums to stimulate the economy. The Chinese programme is worth 460 billion Euros, an enormous sum amounting to almost 20 per cent of Chinese GDP. The country can already point to some success: in December 2008, the value of awarded credit reached an all-year monthly high at 780 billion Yuan. There appears to be no credit crunch in China. Japan, too, though already highly indebted, is spending close to 10 per cent of GDP to the same end, whilst the US is in the process of passing a stimulus package worth 6 per cent of GDP.

Compared to this, the measures taken in Germany and other European countries are modest to date; the stimulus packages amount to between one and two percent of GDP. Abroad, this has prompted criticism of the hesitant politics pursued by the world's leading exporter. Understandably, European and non-European countries are expecting measures boosting demand by a considerable amount. Berlin's hesitant approach could turn out counterproductive in the long run: If the current crisis is not overcome relatively quickly, there is a danger that protectionist tendencies will increase in a number of countries, which would hit an exporting country like Germany particularly hard.

Who benefits from the crisis?

The current crisis is probably most useful for the world's largest lender, the People's Republic of China. Once more China presents itself as an actor able to tackle crises with a cool hand. This improves China's reputation both within Asia and in the world economy at large.

In the Asian Crisis in 1997/98, China supported Thailand financially by contributing to the rescue funds for the country. But even more importantly for the companies in the region, China did not take part in the large scale devaluations in Asia as practiced by other countries and instead kept the currency peg constant. Its motives were not altruistic: the danger of provoking new inflation by considerable devaluation suggested that keeping the exchange rate constant was the best policy. The Chinese currency had already been considerably devalued in 1994, from 5.7 to 8.7 yuan per dollar. Although China was not only and probably not even mainly interested in the economic stabilisation of the region, it is still worth noting that the spiral of currency devaluation in the region only came to a halt when China refused to devalue.

Today, more than ten years after the Asian Crisis, China is the most important trading partner for all Asian economies. Asian states have benefited from intensive economic exchange and cooperation with the People's Republic. Almost half of China's external trade is intraregional. Even for Japan China is now the most important partner. In addition, the country is not just the second largest exporter but also the third most significant importer after the US and Germany. Particularly in times of crisis China was keen to position itself as an important economic partner for many countries.

For Europe, this means that taking the lead in the management of a crisis can have considerable benefits. Many a commentator today points out that – considering the welfare of future generations – it is irresponsible to react to the crisis with a debt-financed increase in government spending.

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However, it is precisely in the interests of future generations in European states to further open their economies in a crisis, stimulate demand and hence make Europe the an important player in international trade.

But Europe cannot take the lead in restructuring financial markets unless it finds a common voice and engages in a concerted effort to stimulate demand in order to dampen the effects of the crisis. In the discussion of global financial governance, those who can point to successful experiences of crisis management will once more have a distinct advantage.

Compared to this, national efforts to condemn tax havens and offshore financial centres which are increasingly discussed at the moment are counterproductive. These measures can only be successful in cooperation with European partners; they cannot be passed against their will. Those desiring to hold on to free capital flows will simply be enticed to move their activities to countries with fewer regulations if specific national rules come into force.

Conclusion

At the moment, it is not obvious that Europe could play a prominent role in restructuring financial markets. Whilst East Asia and the US are already employing stimulus packages of unprecedented size to tackle the crisis, Europe appears petrified by the economic shock.

Looking beyond European borders might suggest some viable options. In East Asia, the competition between China and Japan is likely to produce a situation in which both states intend to surpass each other in terms of rescue measures. But both countries have learned that a crisis is a crucial moment and will define the future role of a country or a region. For Japan, a failure to act decisively could determine the competition for leadership in East Asia in favour of China. Therefore, Japan is not intending to be outdone by China yet again, as in the Asian Crisis ten years ago, and

China is employing strategies that have been tried and tested in previous crises. In the US, President Obama will stimulate demand with a package worth around 600 billion Euros, risks notwithstanding. Measured as a percentage of GDP, this would correspond to a German rescue package worth 150 billion, three times the amount currently intended. Considering the relatively robust constitution of public finance in Germany, the economy would be able to digest a significantly higher level of stimulus than currently envisaged. The German government could and should stimulate demand at home and abroad using effective short term measures, to demonstrate that Germany is prepared to accept responsibility in the global economic crisis.