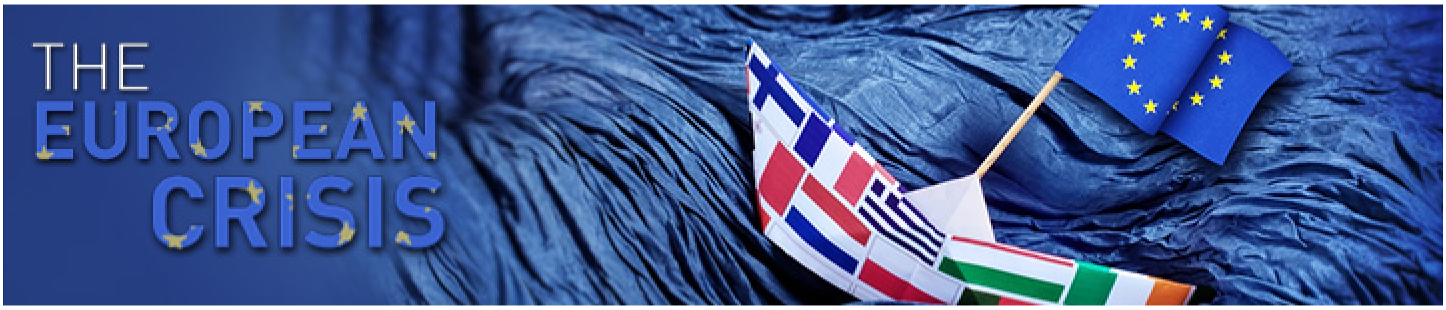
TOMORROW'S CHALLENGES



THE EUROPEAN CRISIS

HOW IT COULD HAVE BEEN AVOIDED, AND WHAT WE SHOULD DO NOW

By Professor Nuno Fernandes – June 2013

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Good governance by European institutions could have reduced, or even avoided, the impact of the region's ongoing crisis. Unfortunately, the European Central Bank (ECB) took far too long to address the issue, drawing out the situation and placing avoidable strain on every European country.

What the ECB should have done at the start of 2010

The bank should have stepped in the moment problems arose to ensure that solvent countries were not under unfair attack by financial markets. It did eventually do this, but not until September 2012. The best parallel here is the way in which the UK government handled the crisis at Northern Rock, the bank. There we saw pictures of people queuing in the streets to withdraw their money from the bank, prompting fears of a run on the bank. The government quickly promised that it would guarantee all deposits held in Northern Rock – which reassured people, who went home, which in turn allowed the situation to be resolved in an orderly fashion.

The ECB, which monitors the whole European economy, should have followed the same principle. It should have stepped in and guaranteed countries' debt when it realized that their key institutions were under attack. This would have allowed it to stop the problems while they were still small; remember, Greece started with a very minor bond issue that didn't go through as expected, in early 2000, and which was allowed to escalate to an entire Greek default.

Quick, early action would also have stopped attacks on other countries, because the ECB's willingness to stand up to the challenge would have made such activity less attractive. Instead, it said, effectively, that each country should solve its own problems, which created contagion across the region – just as the UK government realized that other banks in Britain would have been threatened had it not guaranteed deposits in Northern Rock.

Where we are now

In September 2012 the ECB got a new governor and its policy changed. It became more reactive to the market, and promised to protect solvent countries with good fundamentals from unfair attack – essentially, what it should have done two and a half years earlier.

We can already see the benefits of this approach. The yields on debt have dropped in all southern European countries, meaning that the cost of that debt has fallen by between 30 percent and 50 percent. This in turn has increased stability, and put us on the track to recovery.

What we need now is for the European Commission and the International Monetary Fund to step in and focus on guaranteeing that growth will be restored, that we will have more than just fiscal austerity in the coming months and years. The current emphasis on austerity has seen growth slow further and further, which in turn means that less tax is being collected and thus deficits are increasing. When deficits grow, so do problems, so we must moderate austerity by adding growth targets in order to escape this spiral.

This focus on growth should be paired with a more joined-up fiscal approach across Europe. The recent situation in Cyprus has made it clear that we cannot have a Eurozone with a common currency without also integrating aspects of monetary policy, fiscal policy, and the regulation of financial institutions. A European-level banking regulator would offer significant advantages, not least that it can be difficult for national regulators to oppose powerful, politically-connected national banks.

How to improve growth

There is no magic bullet that will bring back growth. Indeed, most solutions need to be built by individual countries in response to their particular needs. However, there are some things that can be done at a European level. One of the most obvious is the integration of product markets to allow the development of big European corporations that have the scale to compete with companies based in China, the US, and other parts of the world.

I would also like to see more countries in Europe – and their businesses – pay attention to opportunities outside the region. The common currency created a strong incentive for businesses to focus on European markets, but this means that they are not giving enough thought to Asia, the Middle East, and other parts of the world that are actually growing. Focusing only on intra-European trade is not a recipe for growth, given that the region itself is not growing.

Finally, European governments could learn from the way major corporations manage their relationship with investors. Big businesses take an extremely professional approach to dealing with institutional investors: they make sure that they know what their strategy is and what their fundamentals are so that, even if they have a bad year, investors are prepared to trust the CEO and his or her strategy because they still trust what the company is doing.

Replace institutional investors with international creditors in this analogy and you can see how good communications between them can help. Governments can put their current numbers into context and explain what measures are being taken to restore growth and stability.

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