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DOES AN AUSTERE EUROPE HAVE A FUTURE?

*Michael O'Sullivan**

The Eurozone crisis is a profoundly structural one in that it has unmasked the inappropriateness of the monetary union for certain member states and the complacency of its governing class. The aims and raison d'être of the European project must now be rethought in an original way and communicated in a clear way to its bewildered citizens. It needs new and reformed institutions, and above all it needs leaders. Specifically, in the economic arena, policymakers need to broaden the range of policy options to actively consider debt restructurings and the exit of some countries from the Eurozone.

It is hard to imagine a group of European leaders drafting a set of essays comparable to the *Federalist Papers* that would elaborate the structures and paths to lead the Union out of its economic crisis. Indeed, though it is difficult to imagine any set of politicians internationally matching the foresight of Hamilton, Jay and Madison, authors of the *Federalist Papers*, the comparison is valid and important. Europe (as understood by the Eurozone) is a young construct, imperfectly formed and enduring a difficult adolescence, not unlike the fledgling US monetary system in the late 18th century. It requires structures, leadership and strategies in order to further develop, and the response to the Eurozone crisis has shown all of these to be wonting.

As the Eurozone crisis has deepened comparisons with the early years of the American republic have grown, partly because its leaders faced many of the same technical policy issues that now confront Europe such as the need for common "federal" bonds, and because the admirable qualities exhibited by the likes of Alexander Hamilton are so notably absent on the European stage today. Indeed, several commentators have wondered aloud as to "what

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Hamilton would do?" if confronted by our crisis.[1] He was original, independent, a leader and an institution builder par excellence. The solution to Europe's crisis lies in the substance of these virtues.

It also lies in a broader re-imagination of the future of Europe. Specifically, the aims and raison d'être of the European project must be rethought in an original way and communicated in a clear way to its bewildered citizens. It must be re-conceived in way that is as independent as possible from interest groups, political careers of individual national politicians and groupthink of the Brussels establishment. It needs new and reformed institutions, and above all it needs leaders. The danger of course, is that in order to compel leaders to enter the debate, the crisis must deepen, economically and politically.

To date, the remedies applied to cure the periphery countries of their economic ills have been tardy and short-sighted. For some time it seemed as if this was a crisis without an end, without a solution.[2] Despite the introduction of the fiscal compact[3] and the establishment of policy building sites in the form of the ESM (European Stability Mechanism) and the EFSF (European Financial Stability Facility), there has been no authentic attempt to trace the source of the Eurozone crisis to the underlying structures of the single-currency, the EU Constitution and the workings of the Commission. The reality is that the Constitution is unwieldy, the single-currency framework is half-baked and the periphery countries are being crushed by its shortcomings. The austerity ointment that has been applied to save them only weakens them, and in Hippocrates' eyes would violate the principle of "do no harm".

This essay highlights how in the context of complacent and badly coordinated policy making at the heart of Europe, an intellectually misplaced and politically misguided policy of austerity has been put in place to solve the Eurozone crisis. It argues that a more realistic and possibly dramatic approach of debt restructuring (incorporating the exit of one or more countries) and a more pro-growth outlook would have a more positive effect. The essay also aims to

1. R.C. Henning - M. Kessler, "Fiscal federalism: US history for architects of Europe's fiscal union", *Breugel Essay and Lecture Series*, 10 January 2012; R. McKinnon, "Oh for an Alexander Hamilton to save Europe", *Financial Times*, 18 December 2011.

2. The Vix index of market volatility stayed above its long-term average level for 5 months, nearly as long as the post Lehman failure period and as long as during the Asian crisis.

3. The Fiscal Stability Treaty is an intergovernmental treaty which was signed by all of the member states of the European Union (EU) March 2012, with the exception of the UK and Czech Republic. Ireland held a referendum on the Treaty on May 31st.

draw attention to the underlying inadequacy of the Eurozone monetary system and sketches the very demanding program of institutional rebuilding that is required for the Eurozone to survive. The need for a focus on the architecture of the monetary zone has until very recently lacked an urgent place in the political debate, and until this structural issue is addressed, this crisis will continue. Finally, to take a broader, more political and philosophical tack, the essay picks up the much broader theme of "what Europe should stand for?"

1. THE COMPLACENT CONTINENT

The policy response to the crisis has also been startlingly inward looking. While there appears to be relatively little appreciation of how small businesses in places as diverse as Cork, Valencia, Volos and Porto have suffered, there is also apparently little intellectual effort to tie Europe's crisis to the state and evolution of the world economy. Beyond politically convenient attacks on banks, there was no obvious attempt to question the validity of austerity in Europe when output gaps in significant neighbouring economies (i.e. the US and UK) are large and where growth is fragile. Neither is there an attempt to locate some of the necessary structural reforms in the light of the competitive threat to Europe from Asia and other emerging countries. This strategic "blind spot" betrays both complacency and an encroaching irrelevance.

There is a vivid debate in the US on the possibility that America's hegemon becomes impaired or that more bluntly America's empire falls. The very existence of such a cottage industry of concerned commentators[4] is perhaps one indication that American public life is not complacent in the same way that Europe appears to be. Europe it seems is happy to exit the fast lane and fashion itself as the "chocolate producing region" of the world to re-animate Alan Minc's caricature,[5] a region where "strategic yogurt policy" trumps many other concerns.

If evidence of the shambling approach of Brussels is required, its response to the Arab Spring is proof. There was first of all very little appreciation by European policy making elites of the effect that high food prices, lack of economic openness and dysfunction of the rule of law, coupled with high unemployment were having across North Africa. In fact, several European politi-

4. Robert Kagan and John Ilkenberry are some of the leading lights here.
5. A. Minc, "Ce monde qui vient", *Grasset*, Paris 2004.

cians,[6] institutions and companies enjoyed close personal and political ties with the region's tyrants. Once the Arab Spring was underway, the political response from Europe remained cautious and when military assistance was required (i.e. Libya) the reaction was slow and disjointed. Given that the Spring is arguably the most significant political event to occur on the borders of Europe since the Yugoslav conflict or even the fall of communism, it is disappointing that Europe has no plan to revive and rebuild the Spring economies, nor that a muddle of national responses has drowned out a coherent federal approach.

In riposte, supporters of the status quo in Brussels point to the effectiveness of the Union in spreading peace and goodwill across Europe itself. While that is a good base from which to build it is a view that misses the many social and political problems that will manifest themselves as a result of the Eurozone crisis. Further, this is not a perspective that captures the distrust and disenchantment that Europe's citizens now have in the project and its leaders, nor does it capture the growing distrust between individual governments, and between some of the institutions that make up the Union. Eurobarometer[7] polls show this to good effect –the autumn 2011 Standard Survey showed trust in the EU (34%) at its lowest level since 2004, having declined precipitously since the onset of the Eurozone crisis. On average, trust by Europeans in their respective national parliaments and governments is even lower (27% and 24% respectively).

In short, the political effect of the crisis means that deeper union is unlikely to occur by happy consensus and collaboration, and may only come about by coercion. There are echoes of Keynes' "The Economic Consequences of the Peace" here, where the harshness of the "peace" or bailouts imposed on Greece, Ireland and Portugal sows further economic woes and the seeds of discontent.

In order that further "compression" and deeper economic pain are avoided, Europe's leaders must re-evaluate the entire European project, its aims and goals. These are no longer clear to the European public and neither are they robust, having failed at this first test. If they do not do so the project will be further undermined by the splintering around its edges that that may finally produce deeper ruptures. Poor governance in and of Greece was one such splintering, and cheap money transformed this into a full blown fissure.

If not addressed at a deep and conceptual level the cracks underlying

6. Such as the resignation of Michele Alliot Marie, former French Foreign Minister, over her contacts to the Tunisian regime.

7. European Commission, *Eurobarometer 76*, December 2011.

Europe may produce a triplet of shocks not seen since the Great Depression. Then, three shocks –a financial market crisis born out of excessive leverage in 1929, a monetary framework crisis in 1933 and a political crisis of protectionism in 1930 with the introduction of the Tariff (Smooth Hawley) Act,[8] produced a collapse in the international economy. So far the template of the 1930's remains relevant, with the Lehman Brothers period mirroring the Great Crash and the Eurozone crisis aping the breaking of the Gold Standard. The risk is that a third wave of protectionism (even competitive currency devaluations), economic nationalism or anti-globalisation takes hold to shrink world trade further. Indeed, the EU already has several contenders to play the role of Herbert Hoover.

In the 1930's, Europe witnessed nasty and corrosive outbreaks of nationalism and National Socialism followed from this.[9] Nationalism and by extension protectionism are most usually provoked by economic downturns, especially when these are pronounced. The period of the Eurozone crisis has been marked by a number of colourful examples of this. High sales of Thilo Sarazin's book *Deutschland schaft sich ab*, relentless, competitive counter-stereotyping in the Greek and German media, and even the PIIGS acronym are testament to the poison seeping from the pores of the euro-system. More recently, the popularity of more extreme candidates Jean-Luc Melanchon and Marianne Le Pen during the French Presidential campaign reflects the appeal of protectionism and an anti-immigrant sentiment. Moreover, during April 2012, in the Netherlands, the actions of Geert Wilder's Freedom Party led to the collapse of the government.

2. THE AUSTERITY VORTEX

A central element in the growing divisiveness at the heart of Europe is the policy of austerity. It has been readily adopted as the logical cure for the problems of Europe's peripheral countries in the mistaken belief that this would impress bond markets and cure the periphery of its financial prolificacy.

8. This introduced tariffs of up to 60% on overseas goods.

9. A. De Bromhead - B. Eichengreen - K. O'Rourke, "Right-wing political extremism in the Great Depression", *VOXEU*, 27 February 2012. An essay by Eric Koch-Weser on "Radical forces in Germany" in the April 1931 edition of *Foreign Affairs* is also worth reading in this context.

Austerity has been assumed as a groupthink, over and above more daring, incisive and arguably decisive measures such as early and full debt restructuring, exit of the Eurozone by one or more countries or a boost to the rate of growth in the Eurozone economy.

2012 will be the fifth consecutive year of recession in Greece (assuming that as the World Bank claims the Greek recession started in 2008), putting it on track to have a "depression" akin to that suffered by the US between the years 1930 to 1939. The US economy shrank by nearly 30% during the Great Depression, and so far Greece has "only" done 16% (though a chaotic default or euro exit could easily leapfrog it into "Depression" territory). Latvia has in fact suffered a deeper shock, dropping by almost 25% from 2008 to 2010, though it now appears to be rebounding strongly.

Austerity has acted like a quicksand in that the adoption of this policy across Europe compressed growth and further knocked the breath out of the smaller economies. In 2010 smaller countries with stronger economic engines like the Netherlands, Finland and Belgium managed to beat their deficit targets (as forecast by the European Commission) whereas weaker countries (Portugal and Greece) missed by over a full percentage point (in terms of deficit % GDP). In 2011 however, as the austerity groupthink became more profound and Europe's recession deepened, only Germany and Ireland managed to (barely) beat their deficit targets. At the same time, even the Netherlands and Belgium slipped from their tight fiscal moorings, while Spain and Greece missed their budget deficit targets by a full 2% each. Of the periphery countries, only Italy can be expected to flirt with the prospect of a balanced budget by 2014.

The rationale for austerity, as conceived during the Eurozone crisis is Panglossian. Austerity is apparently the best possible way to salvage Europe from recession and through the fiscal compact to tether it to a policy of fiscal rectitude in better times. The theory goes that austerity provokes a sharp, short lived contraction but at the same time so burnishes the credibility of the "victim" country that capital pours into the economy from outside investors and private savings holders.

A prominent, German (American) economist, Rudiger Dornbusch added to his reputation by introducing the notion of "expansionary fiscal contraction", notably the idea that a tightening of belts convinces savers of the seriousness of the tightening country and the inflow of capital brings down debt rates which induces a boost to the economy. In practice, expansionary fiscal contraction has worked for countries transitioning from a weak to a better set of institutions, or where policy waywardness is corrected in the context of more favourable international factors.[10]

More realistic proponents of austerity recommend that it is best applied when it cuts fat rather the muscle of an economic system (such as when a budget adjustment takes the form of longer-term adjustments to pensions and wealth), or when its negative side-effects can be offset by a falling currency or easier monetary policy.

Austerity as applied in Europe today runs into several problems.[11] First, the offsetting factors mentioned above have been constrained and in most cases have worked to exacerbate the problem. The periphery countries are "locked" in the pressure cooker of the Eurozone, with little escape valve (i.e. interest rates, currency) available.

Secondly, the Eurozone's neighbouring economies in the developed world are equally ensnared by indebtedness and suffering low growth. For instance, two of the more significant trading partners with the Eurozone, the UK and US, have large output gaps,[12] and both have long-running, record low interest rate policies (in the UK rates are the lowest since 1994).

In addition, the transmission mechanism of the global economy, the banking sector, is being forced by regulators to contract in the wake of the global financial crisis. The Eurozone crisis sped up the process of deleveraging such that banks did much less business and in specific countries such as Ireland, Greece and to an extent Spain, banking systems have been in a state of dysfunction.

To labour the point a little, austerity has foolishly been administered to economies in a state of shock such that its ultimate effects have been self-defeating. In Spain and Ireland, the collapse of housing bubbles has contributed to a demand shock while in Portugal and to a much greater extent in Greece, there is a competitiveness or "reality" shock in that the relatively poor quality of their economic structures is now being uncovered. Continued doses of austerity administered under these conditions deepen risk aversion and fur-

10. J. Guajardo - D. Leigh - A. Pescatori, "Expansionary Austerity: New International Evidence", *IMF Working Paper*, July 2011.

11. "These results cast doubt on at least some versions of the expansionary fiscal consolidation hypothesis, and on its applicability to many countries in the present circumstances". R. Perrotti, "The 'Austerity Myth', Gain Without Pain?", *NBER Working Paper Series*, 2011.

12. http://stats.oecd.org/mei/default.asp?rev=2&lang=e

ther damage the confidence of households, so setting in train a downward, self-reinforcing spiral (negative feedback loop) in activity, sentiment and funding. To make matters worse, the cross-fire of several policy errors from statements at the Deauville summit in October 2010 to the soap operatic nature of subsequent summits have very simply exacerbated the dearth of confidence that markets have in policy makers.

In this area the discussion of what is known as the "multiplier" is very important. This refers to the sensitivity of a country's economic activity to changes in spending for example. When the multiplier is low, a large cut in spending has a proportionately smaller effect on growth. What is not quite clear is whether under conditions of stress and risk aversion, small cuts in spending can cause a large retrenchment in household activity as people seek to build up precautionary savings,[13] and even more activity to the black economy.

A final objection relates to economic structure. The rationale of austerity as it applies from German economic orthodoxy[14] is that a dose of austerity ultimately makes you fitter and stronger. This holds provided that the austerity is not administered under conditions of chaos, very importantly if the underlying economic engine is relatively strong and where the public have internalised the importance of austerity owing to their economic history (i.e. hyperinflation in the German case). Again, the trouble here is that when industrial structure is considered, Greece, Portugal, and Spain are relatively weak when compared to more advanced and export led economies of the Netherlands,[15] Germany and even Ireland. For instance, trade to GDP ratios for Ireland and the Netherlands are nearly three times those of Portugal and Greece. The point here is that industrial structure in the weaker Eurozone countries is weak by comparison to that of Germany so that under the German led logic of austerity, the effect is to injure the periphery economies rather than make them more fit.

In summary then, austerity as an economic tonic works best when the

13. There is in fact growing evidence that the fiscal multiplier varies over the business cycle, in that it is large during periods of contraction and smaller during expansion. See P. Michaillant, "Fiscal multipliers over the business cycle", *CEPR Discussion paper*, No 112, January 2012. Also A. Auerbach - Y. Gorodnichenko, "Measuring the Output Responses to Fiscal Policy" *NBER Working Paper No. 16311*, August 2010.

14. S. Dullien - U. Guerot, "The long shadow of Ordoliberalism: Germany's approach to the Euro crisis", *European Council on Foreign Relations Policy Brief*, February 2012.

15. Belgium, Austria and the Netherlands are the top three most globalised countries in the world KOF Globalisation Index, http://globalization.kof.ethz.ch/.

country administering it has its own currency and interest rates, when neighbouring economies are relatively healthy and where a credibility gap can be closed by some stringent policy making. Ireland in the late 1980's is a good example. Austerity does not work when applied over the course of four or more years to countries that do not have sovereignty over monetary policy, that endure broken banking systems, whose households are in the grip of a severe economic shock, whose neighbouring economies are weak and who still suffer the side-effects of an adolescent economic structure. Ireland, Spain, Greece, Portugal and possibly even France are examples.

The economic rationale for austerity seems misplaced in the circumstances of the smaller Eurozone countries and in the context of a downturn in economic activity. There is also a disturbing subtext to austerity which is that at times its rationale has been to punish the wayward members of the Eurozone. In the same way in which short-selling bans were triumphantly heralded as the solution to the banking crisis, and the transaction tax on financial market activity is seen as a coherent part of the solution to the Eurozone crisis, austerity is associated with a perceived moral[16] element in terms of bringing southern countries to heel.

The psychological or behavioural appeal of austerity as a mantra is that morally it appeals at a very basic level, however damaging this may prove. It is also convenient for the way in which it gathers into a groupthink, and helps to shroud judgement of the underlying fault-lines in the Eurozone monetary system. The logic here is that the system cannot be wrong, it's that some members are simply too weak and need a diet of rigorous austerity.

At the same time, some countries have benefitted from the side effects of austerity. Germany's political power in Europe has gained from its relative financial strength and has granted it a guiding hand in shaping the bailout packages for the periphery states.[17] In economic terms, Germany, its unions and industrial leaders deserve great credit for the way in which they have reformed its labour market in the mid 2000's and for the discipline with which real labour costs have been controlled. Germany's wage restraint and the productivity gains that have been achieved are a model for countries like France to follow. However, in a similar manner to how countries like Ireland enjoyed

16. P. De Grauwe, "The Euro-zone as a morality play", *Intereconomics*, Vol. 46, No. 5 September/October 2011.

17. Details of some countries' budget plans were leaked from the German parliament, before the sovereign parliament members had seen them. *Financial Times*, 18 November 2011.

highly stimulative low real interest rates, the effect of the (weaker) common currency has been to super charge German industry, especially its exporters.

The effect of the single currency has been to grant Germany a currency that may well have been weaker than the original Deutschmark would have been. This was most likely the case during periods of intense financial market stress in early 2009, mid-2010 and late 2011. In addition, from a competitive point of view by cutting off the avenue for currency devaluation to the likes of Spain and Italy, the Eurozone structure has curbed their ability to out-compete German exports through currency depreciation. Further, the offshoot of the financial contagion from the likes of Greece and Italy compressed German bund yields to their lowest levels in decades, again below where fundamentals would suggest they trade.[18]

In this respect, and setting aside the contractionary effects on the banking sector (though German banks have largely seen deposit inflows) from financial market stress and regulatory headwinds, the German economy became the inadvertent beneficiary of other countries' economic pain. To a degree, other "true sovereigns" around the periphery have benefitted from the travails of the Eurozone in terms of enjoying low bond yields. Switzerland, Sweden and the UK all saw long term interest rates fall to historically low levels, though the inflow of capital to "safe" Switzerland produced its own dilemma with the Swiss franc pushing close to parity with the euro by August 2011 (from rate of 1.40 twelve months previously).

The case of the "old sovereigns" (developed countries with well-established institutions, free floating currencies and independent central banks) helps to eke out the shortcomings of the euro-system. Some of them, notably the UK and the US have debt to equity ratios that are higher than those of many Eurozone countries (though at the same time have lower interest rates). Indeed, it appeared to surprise Eurozone politicians that at the end of 2011, according to IMF figures, the US had a gross government debt to GDP ratio of 100%, the Eurozone a ratio of 87%, with the UK close by at 83%. Moreover, the US also suffered a downgrade in the summer of 2011. Still, US Treasury bonds and UK gilts rallied strongly as the Eurozone bond market was torn apart. Both the Federal Reserve and the Bank of England have engaged

18. At the end of March *Der Spiegel* reported that Germany could save EUR 30bn in interest payments on its debt because of abnormally low interest rates. In September 2011, the 10 year bund yield dropped below 1.7%, its lowest level in over thirty years. Since then bund yields have ominously dropped below those of Japan falling to 1.4% in May 2012.

in quantitative easing, something that the ECB has only done in a very roundabout way at the end of 2011. In the US, austerity has been circumvented (the Super Committee failed in November 2011 to agree a plan to reduce the US budget deficit)[19] and the economy is now undergoing a moderately healthy recovery, while in the UK austerity measures are curbing growth, though they have not destabilised gilts and sterling.

3. INCOMPLETE AND INAPPROPRIATE

The essence of the argument here is that countries like the UK are free to mobilise the full range of policy tools in support of their economy, and notwithstanding the ebb and flow of the economies of their trade partners, they are intellectually independent in the sense of being able to decide the course of action to return to economic health. The same cannot be said for France and Italy, two economies of similar size to the UK, with similar economic fundamentals. For them, the Eurozone as a monetary system is either incomplete or inappropriate. This is even more the case for the smaller countries whose economies are being pushed and squeezed by the common monetary system.

Ireland is a case in point. Its boom years were partly fed by inappropriately low interest rates from Frankfurt, coupled with poor policy making and the absence of strong regulation in Dublin. No correcting mechanism was put in place to take account of the fact that monetary policy set in Frankfurt could at times be too hot or too cold for one of the smaller economies of the Eurozone. In this case, what a country like Ireland requires is clever and flexible use of fiscal policy to offset common monetary policy. A fiscal compact will do the opposite and will tie both policy making hands behind the backs of smaller nations.

As the crucible for so many economic "experiments" Ireland should have plenty to offer the debate on the future structure of the Eurozone and it should fight hard so that the lessons of its bubble are incorporated in the evolving structures of the EU. In this spirit, attention must be drawn to the underlying flaws of the Eurozone system and its inappropriateness for all but a few of the core economies. It will either consume the weaker members and render itself asunder, or, more constructively its members can embark on an

19. www.deficitreduction.gov

institutional project of Hamiltonian proportions to rebuild and redevelop the monetary system.

4. EUROPE'S HAMILTON PROJECT

Europe needs to complete the building of its financial architecture, to take account of the deficiencies of the current Eurozone system, and more importantly to equip it for the 21st century, where competiveness relative to Asia will become a major issue, and where the effects of demographics and low growth will place even more pressure on the common currency.

In terms of the building project that needs to be embarked upon, perhaps the most neglected is a viable and credible exit mechanism for weak or recalcitrant states. It is arguably the case that if Greece had left the union in 2010, the contagion to other countries may have been lessened. Much depends on the manner with which "ejection" or "rejection" occurs, and in particular on the extent to which legal groundwork has been prepared for a possible rupture, in sense of contract law, eligibility of currencies, bank reserves and corporate activity. A stabilisation package may be needed to cushion the blow of an exit.

Calls for a Greek exit have grown of late, and as pain levels rose even senior European politicians pondered this publicly. The standard response was that in order to leave the euro, Greece would have to leave the Union itself. There is a policy gap here[20] that must prepare the ground for an exit process that is as least disorderly as possible. In addition, there should be a sense of n-ear permanence over "exit". The Eurozone, for the sake of credibility should not be something into which there is a revolving door policy. In addition, the existence of a "trap-door" in the euro mechanism may reduce the moral hazard problem that has worried policy makers in that it serves to discipline Eurozone member states with the prospect of relegation.

The reality of an "exit" implies that a country does not have the institutional quality and industrial strength to play a part in the economic life of the Union and achieving a turnaround in these factors will simply take decades. While Greece and Portugal where industrial structure and "rule of law" lag behind the EU average are the prominent candidates for exclusion, the estab-

20. It seems that only euro-sceptics such as those awarding and competing for the Wolfson Prize are willing to consider in detail the prospect of an exit for a Eurozone country.

lishment of an exit process is also most relevant for Eastern European states such as Estonia, Slovenia and to a lesser extent Slovakia, as well as the "aspiring" nations from Poland to Romania to the Czech Republic.

The existence of an exit mechanism and the lessons of the Eurozone crisis may likely curb the desire of the "new periphery" to join the single currency and should temper the willingness of Brussels to allow them in. In terms of policy, it most likely means that the "new periphery" countries need another wave of institution building, tightening adherence to the rule of law (especially in the likes of Bulgaria and Romania) and building up expertise in economic management.

While the "new periphery" needs to undergo a step change in terms of institutional quality so that its economies are more robust and on more of a par with those at the centre of the Eurozone, the centre also needs to change in terms of institutional quality. Of the many deficiencies brought to light by the crisis, poor coordination[21] and lack of financial market expertise are two very prominent ones. They highlight the need for a "super- finance" ministry at the heart of Brussels that is superior in terms of expertise, power and reach than the current incarnation. It should be the equivalent in stature to the US Treasury, and as well, if not better equipped in terms of human capital.[22] Indeed, the Eurozone crisis exposed Brussels' limited grasp of the effects and workings of the financial markets, as they pertained to economic policy.

The Euro Treasury will perform several functions –first to guide the process of institutional reform in Eurozone countries in much the same way in which the OECD provides policy advice, but with a "bigger stick". Importantly, the Euro-Treasury must act as the nexus between financial markets, national economies and the trade flows associated with globalisation. Managing and offsetting financial market crisis is one of the most important factors in the survival of new nations and young economies,[23] and it should not be different in the case of a fledgling currency zone. As crisis management has been one of the weaknesses of the Commission, it now needs to be improved dramatically so that the side-effects of emergencies (a weakened and

21. A good exposition on this comes from Lorenzo Bini-Smaghi http://www.ecb.int/press/key/date/2011/html/sp110708.en.html

22. "US Treasury: Manhattan Transfer", *Financial Times*, 5 February 2012.

23. For example, A. Foxley, "Lessons from Chile's Development in the 1990's" in T. Besley - R. Zagha, (eds.), *Development Challenges in the 1990's, Leading Policymakers speak from experience*, Oxford University Press and World Bank, Washington DC. 2005.

disorderly Russian economy, a Chinese recession, a soft commodity price bubble and protectionism) can be managed.

One of the projects that a Euro-Treasury must oversee is the inevitable (if the Eurozone is to evolve) creation of a deep Eurozone bond market where common bond are issued across all Eurozone countries, and potentially where if "extra" debt needs to be issued this is done by individual countries at a premium/discount to "Eurobonds" along the lines of the blue/red bonds idea[24] proposed by von Weizacker and Depla. The passage towards a Eurobond will in all reality only occur when most Eurozone countries have managed to cut debt levels, either by selling state assets, growing and inflating their economies or by restructuring their debt.

It may be too late however by the time debt levels have fallen to acceptable levels, and in certain respects policymakers may by then be fighting yesterday's crisis. One means to speeding the passage towards a euro-bond issue may be for indebted states to offer collateral in respect of "excess" debt.

A further prominent role for a European "Treasury" is the structuring and collection of a Eurozone wide tax, for the purposes of supporting a Eurozone capital fund, a crisis and business cycle stabilisation fund and in certain respects a strategic investment fund.[25] Other tax streams may also flow along similar lines, such as a pan-European defence tax whose receipts could be spent on pan-national assets such as heavy lifting aircraft, internet defence systems and measures to protect against international organised crime and terrorism.

5. WHY IS GROWTH IMPORTANT?

In the context of Europe's dominance of the league tables of human development, culture and its high absolute and relative levels of wealth and income it may seem out of place to stress the need for an overhaul of Europe's economic

24. Several proposals on such a structure have been put forward: W. Boonstra, "Towards a better Stability Pact", *Intereconomics*, Vol. 40, No. 1, January/February 2005, pp. 4-9; P. De Grauwe, W. Moesen, "Gains for all: a proposal for a common euro bond", *CEPS Commentaries*, 3 April 2009; S. Eijffinger, "Eurobonds-Concepts and Implications", *Briefing: Note to the European Parliament*, March 2011. The more attractive is presented in J. Delpla - J. von Weizsacker, "The Blue Bond Proposal", *Bruegel Policy Brief 2010/03*, May 2012.

25. This may be structured like a sovereign wealth fund though its aim is to act as a buffer on markets, especially in the case of excess and deficit of liquidity.

institutions and the creation of mightier ones, notwithstanding the Eurozone crisis. The fact however, is that, compared to the United States and more particularly the various poles of the emerging world, Europe's influence will wane, more quickly so if it remains as disorganised and economically disunited as it currently is. In this respect, another part of the geo-strategic equation is the need to internalise growth and real competitiveness in the minds of European politicians, with a focus on those operating in Brussels and Frankfurt.

A quick track through time, by virtue of the late Angus Maddison's economics database[26] and then with a little help from IMF forecasts helps to make this clearer. In 1820, China accounted for 32% of world GDP with 30 European countries combining to account for only 23%. The US was a minnow then, with an absolute level of GDP at only twice that of Ireland and 1.7% of the world total. By 1870 the US had shot to nearly 9% of world GDP, Europe was dominant at 33% and China had slipped back to 17%. Fast forward to 2030 where if we assume a long-run growth rate of 55 for China and a more modest European large country average growth rate of 1.5%, then the Chinese economy will be larger than that of the five large European countries (UK, Italy, Spain, France and Germany), and by 2050, nearly twice as large as all five combined.

It is a long way away, indeed as "far" away from today as the mid 1970's, but by 2050 Europe's economic role in the world will have shrunk from a position of potential leadership to a relatively minor player, behind China, the US and India. Other emerging countries on Europe's borders will, if recent growth rates can be sustained, percolate towards the top of the national output rankings, with Turkey and Russia leading the way here.

As it rises, the emerging world is fast changing its appraisal of Europe. Take Turkey as an example. In the 1990's Turkey was enticed by the prospect of EU membership and successfully used the standards and frameworks set out as the terms of possible membership to advance its economy. Despite a relatively short-lived crisis in 2000-2001 Turkey's economy has thrived in the past twenty years, and its society, though perhaps not its public life has been more modern. While it was once a prize for Turkey to have the opportunity of joining the Union, it would now be a prize for the Union to have Turkey in its fold. Turkey is now a model for the Arab Spring countries, for whom Europe has had little money and scant strategic advice.

26. http://www.ggdc.net/MADDISON/oriindex.htm.

On a grander scale, the two large Asian nations, India and China[27] now have a much more superior view of Europe, and the temptation is to feel that the Chinese man in the street regards Europeans as rich and lazy. China in particular looms as a strategic opportunity and threat. While currently a source of revenue growth to many European companies in the near future may provide them with their next shock as it transitions to more steady growth. In the longer term, China will gain more power at a geo-strategic level, in the governance of world institutions, in terms of its weight in financial markets and the activities of its sovereign wealth funds and, of course, its growing role the marginal factor in most commodities markets. It may also become a more taxing trade partner in terms of its search for innovation, respect for intellectual property and the vexatious activities of Chinese internet hackers. To match this Europe needs a stronger, more coherent presence.

So, the looming geo-strategic importance of many of Europe's former colonies will become increasing problematic from a strategic point of view and in simple terms underlines the need for a more cohesive political and economic structure. It also underlines the need for a faster and more nimble pace of growth in Europe. At a human level it emphasises the need for policy-makers to internalise rather than pay lip-service to the need for growth, as a solution to the immediate debt crisis and as a competitive strategy vis-à-vis emerging economies.

In the context of the Eurozone crisis, there are with the benefit of hindsight of course, several things that could have been done better from the point of view of stimulating growth. First, policy accidents such as the political statements at the Deauville summit that frightened liquidity out of the periphery bond market have to be avoided. One suggestion is tighter marshalling by heavyweight "Sherpas" (who have banking backgrounds - not unlike the role played by Jean-Claude Trichet at the G7).

A second suggestion is that the ECB should have been more responsive to the threats to the business cycle posed by the crisis and should have undertaken earlier, more aggressive monetary policy. The two long-term refinancing operations the Bank launched managed to break the Gordian knot tying bank financing and stressed government bond markets, but ultimately it may simply have created another feedback loop between, at least, the Spanish and Italian banks and their sovereign bond markets. In this respect, an independ-

27. K. Mahbubani, "The New Asian Hemisphere", *Public Affairs*, New York 2008.

ent overhaul of the mandate of the ECB is overdue, as is the composition of its governing council. This is intensely homogenous and lacks of broad experience[28] outside the areas of technical economics (in either academia or central banking).

In many senses, the ECB has come through the crisis well, and is the exemplar of what a singular, coordinated pan-Eurozone body can achieve, especially when confronted with the spaghetti of inter-governmental, banking and policy making relationships. One area where it, and to a far greater extent the Commission, member state governments warrant far greater scrutiny is their failure to consider the necessity to allow individual banks to pass into bankruptcy, to quickly recapitalise banks, and their reluctance to fully restructure the debt of individual governments.

Such moves were apparently not undertaken because they could potentially lead to greater short-term market volatility (a la Lehman Brothers). These considerations must be balanced against the current situation economic and financial volatility continue to be a strain to much of Eurozone, where the trade-offs and possibilities for collateralisation that could have arisen from restructuring need to be considered in more detail. In addition, necessary debt restructurings (of banks and countries) would have leeched much of Europe's financial stress and importantly provided the moment from which the beginnings of a euro-bond market could be established. Necessary debt restructurings would at this stage most likely have drawn private capital into periphery countries and banking systems and enabled a recovery. Instead banking systems in countries like Spain, Italy and parts of Germany are sclerotic and in many countries small and medium sized businesses are suffering. Structural funds should also be unleashed to support activity in countries suffering from economic shock.

Ambitious infrastructure plans such as a Mediterranean Revival infrastructure project for the North and South of the Mediterranean could be led by the likes of the European Investment Bank, with qualified ECB backing given to bonds issued to finance infrastructure projects. Further, the EUR 120 billion growth package announced at the June EU Summit is a nod towards growth rather than a philosophical change of mind towards a more re-growth stance.

28. Consider the depth of experience that individuals such as William McDonough brought to the US Federal Reserve system.

In summary, the remedy proposed here is different to the road taken by Europe's leaders. This essay proposes very severe treatment of countries that have failed to make the grade economically and institutionally, with an exit of one or more countries from the Eurozone a very likely event. In addition, policymakers must hasten towards the "truth" of Europe's indebtedness problem by undertaking multiple restructurings of government and bank debt. The effect of the two above measures will draw in private capital and likely permanently ease the stresses on the Eurozone financial system. In the immediate future, punitive austerity measures must be eased, and growth-promoting infrastructure projects must accompany on-going competiveness reforms.

A greater, long-term project of rebuilding the financial institutions at the heart of the Eurozone is a next and very significant step, taking in the creation and staffing of a European Treasury a prominent suggestion.

6. WHAT DOES EUROPE STAND FOR?

If this were undertaken then it would market one of the great advances in modern financial and economic history. But it is not enough. The poor coordination and sub-standard policy making and implementation seen in the financial arena have their echo in other policy making quarters such as defence and energy. In this respect Europe needs a philosophical overhaul, from the bottom up and in a spirit that is very much the opposite of Valery Giscard's lofty and drawn out stewardship of the EU Treaty. In fact, such an approach needs to produce a short statement of values and intent, recognisable by all Europeans.

Europe needs to rediscover what it stands for, relative to its long and deep history and to a changing world. The philosophical topic of "progress", from a human as well as an economic point of view also deserves discussion because in many material senses "Europe" has peaked in that the vast majority of its citizens are "secure" and enjoy a degree of liberty that is absent in many other parts of the world. Europe, in an economic, political and legal sense may find that it chooses to distinguish itself by the quality of its intangible infrastructure[29] –facets such as the quality of education, research and development,

29. "Intangible Infrastructure", *Credit Suisse Research Institute*, May 2009; see also M. O'Sullivan - R. Miller, *What did we do right?*, Blackhall Publishing, Dublin 2010.

healthcare, institutional quality and especially the rule of law. These are areas where many European countries lead the world, where there is a rich pedigree and where in the future Europe can distinguish itself competitively from at least the merging world. Some of these values are espoused in the 2020 Lisbon Agenda though they are not grounded across a broad range of areas (e.g. culture, law) and are poorly communicated and implemented. If Europe had better institutions, strong intangible infrastructure, this crisis may never have happened.