European Responses to the Global Economic Crisis

The economic crisis that began in the summer of 2007 is having a powerful negative effect on popular attitudes toward European institutions specifically and toward European integration more generally. For the first time in its history, the European Central Bank (ECB) has fewer people who claim to trust it than distrust it. The balance of trust in the European Commission and the European Parliament is still positive, but only just. Meanwhile, and somewhat ironically, most Europeans express the belief that only international policy coordination can lead them out of the crisis and that levels of coordination are currently inadequate. The European Union (EU) may be unpopular, but it is no less necessary as a result.

The purpose of this brief is to map the politics behind European responses to the global economic crisis. The brief is structured in four parts. The first provides an overview of the public opinion polling data. The second sketches how EU institutions actually help. The third shows where the coordination of national policies breaks down. The fourth explains why the United States and the rest of the world will suffer unless the situation improves.

Popular Commitment to Coordination

The European Union has a long history of influence over economic policy formation. The injunction for member states to regard their national policies as a matter of common interest dates back to the original (1957) Treaty of Rome. More recently, however, such influence acquired something of a popular taint. When the Council of Economics and Finance Ministers (Ecofin Council) reprimanded Ireland in February 2001 for its failure to comply with the EU's "broad economic policy guidelines", many complained that a large country would never have been treated so roughly. When the same Ecofin Council set aside the excessive deficits procedure rather than sanction France or Germany in November 2003, many more thought previous complaints about the inequity of European "coordination" were confirmed. Even worse, the charge of inequity began to chip away at small country attitudes toward European integration more generally – first in the failed Irish referendum on the Nice Treaty in June 2001, and then later in the Dutch veto of the European Constitutional Treaty in June 2005.

Over the last couple of years, much of the process of economic policy coordination has retreated into the background. As a result, the March European Council summits that focus on these issues have become increasingly low-key affairs. That is not to say, however, that policy coordination is off the agenda. On the contrary – and in the current crisis – it is arguably more necessary than ever. What is surprising given the recent

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history of controversy is that it is also widely recognized as such. When Eurobarometer pollsters went into the field across the EU in January and February 2009, they found clear majorities in favor of coordination both at the European level and in all but one of the member states. The United Kingdom (UK) was the only country where fewer than half of the respondents supported a coordinated response, and yet even there the percentage in support of coordination exceeded the percentage for going alone – 39 to 36 percent.[1]

Much of this sudden enthusiasm may derive from an emotional response to the crisis, which plays out as a desire for someone to take on responsibilities that national governments seem unable to manage. Hence, when asked which institution is most likely to be able to solve the crisis, 25 percent pointed to the Group of Eight leading industrialized nations (G-8), 17 percent to the European Union, and 15 percent to the United States. With just 14 percent of respondents, national governments came out fourth on the list, just ahead of the International Monetary Fund (IMF). Even so, it would be premature to rule out a sincere desire to see national governments working together at the European level. Eurobarometer pollsters not only found broad support for coordination, but also specific belief in the effectiveness of a wide range of different policy measures, including:

- a more important role for the EU in regulating financial services (66 percent);
- EU surveillance and supervision of the most important financial groups (67 percent);
- stronger coordination of economic and financial policies across member states (71 percent); and,
- EU supervision whenever public money is used to rescue a financial institution (67 percent).

Despite this commitment to the effectiveness of EU-level action, however, the sense of polling respondents was that the member states are essentially going it alone. Only 39 percent of respondents across the EU as a whole agreed that their politicians "tended to act in a coordinated way with the other EU countries" as compared to 44 percent who thought national politicians acted "individually" (and 17 percent who did not know). The most extreme case of perceived national autonomy was found in Denmark – where only 19 percent saw policy coordination and 71 percent did not.

While the member states have been going it alone, popular trust in EU institutions has declined. This can be seen in Figures 1, 2 and 3, which show the levels of trust and distrust for the European Commission, Parliament and Central Bank respectively. The situation with the ECB is compounded by the lack of confidence in the euro expressed by respondents. Within the eurozone, 44 percent of respondents *did not* believe that the euro played a role in mitigating the crisis against just 39 percent who believed that it did, and 45 percent believed that they would have been better off with their old national currency. Outside the eurozone, only 36 percent of respondents thought they would be better off if they used the euro rather than their national currency and 46 percent disagreed (preferring, presumably, to keep their national currency instead).

Figure 1: Trust in the European Commission

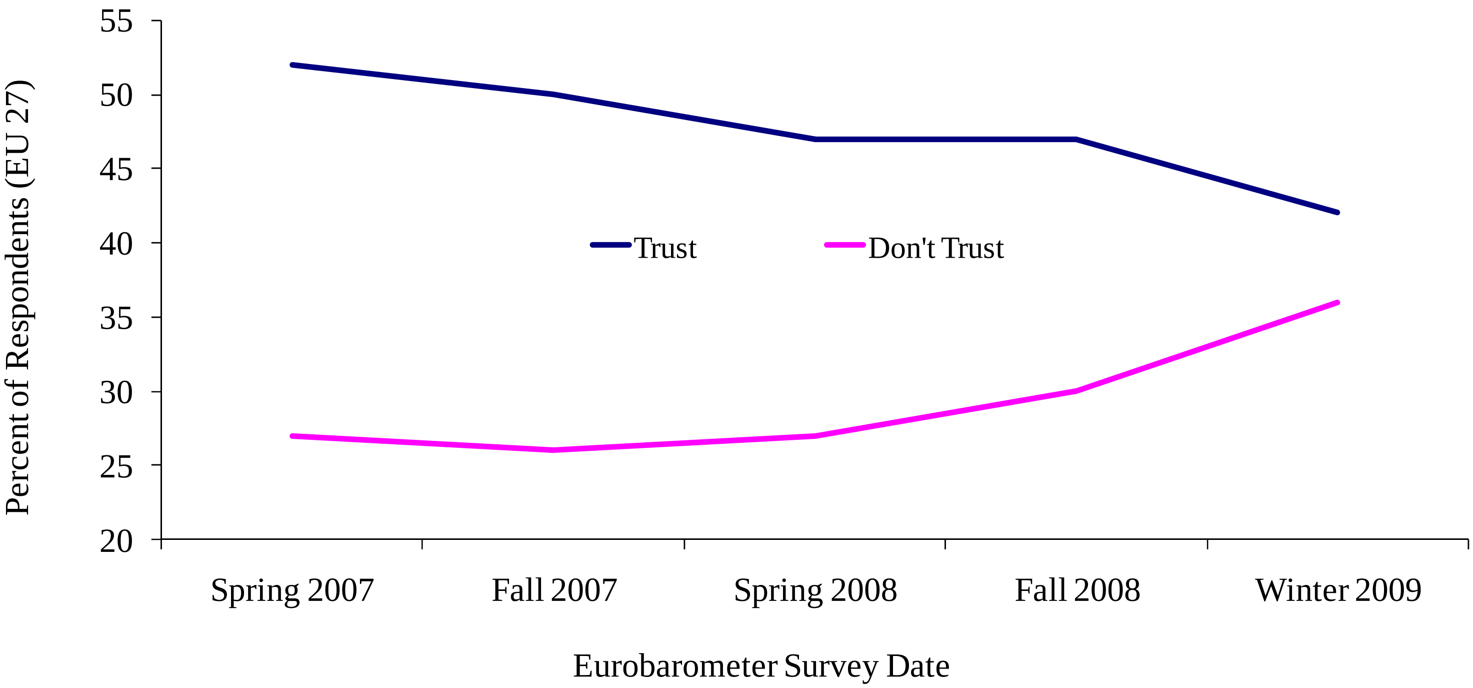

Figure 2: Trust in the European Parliament

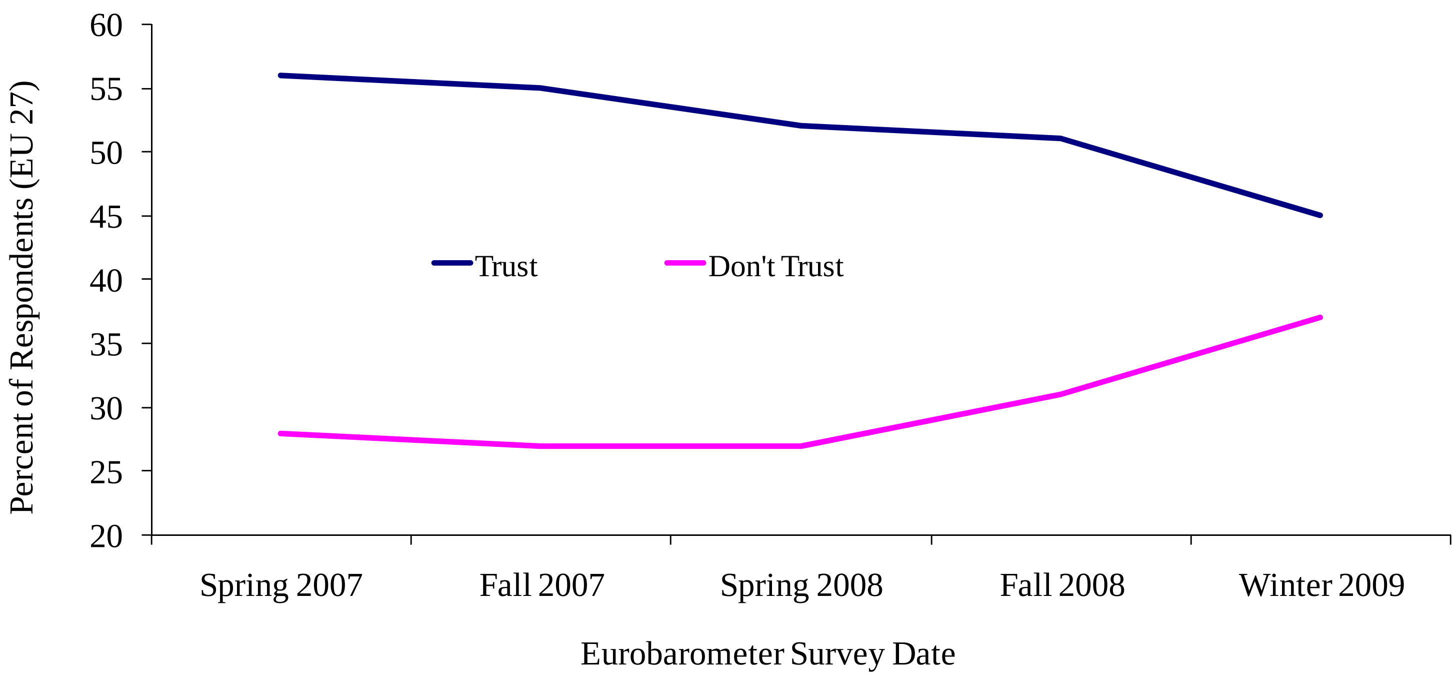

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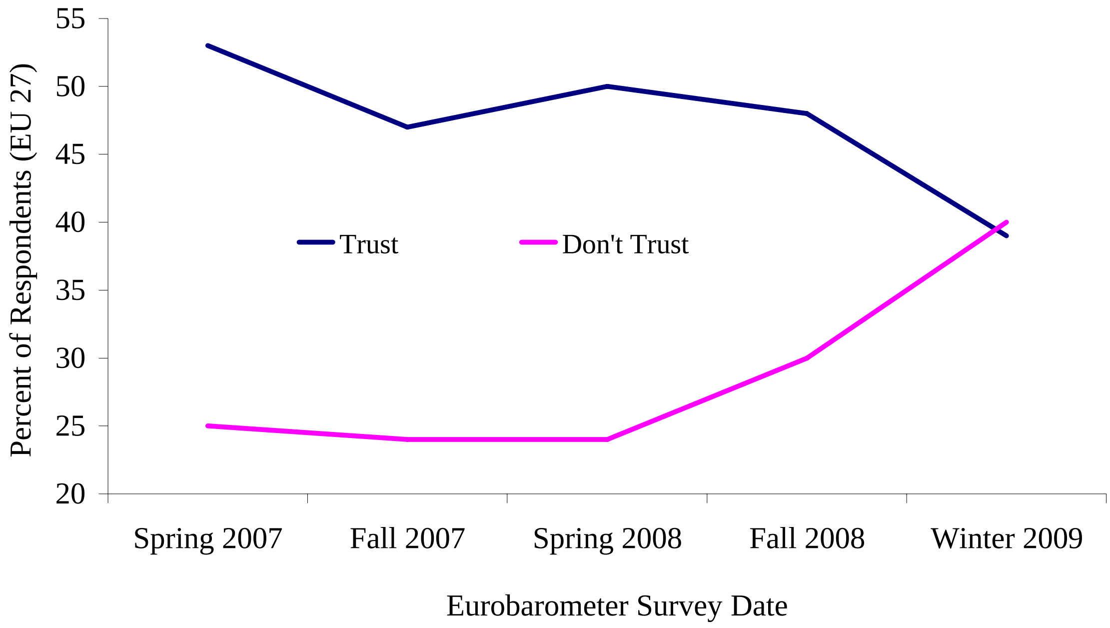
Figure 3: Trust in the European Central Bank



These attitudes toward the ECB and the euro make it hard to fathom what the popular preference for policy coordination really entails. If nothing else, participation in the eurozone is an extreme form of monetary and exchange-rate policy coordination across member states. Moreover, this coordination has clear advantages for all countries concerned.

Policy Coordination Inside and Outside the Euro[2]

The Danish case provides an interesting window on the notion of policy coordination inside and outside the euro. Denmark does not participate in the eurozone, having exercised an opt-out that it negotiated in the 1992 Maastricht Treaty. Denmark is still bound by all the same rules for macroeconomic policy coordination and specifically those that govern excessive fiscal deficits. Nevertheless, it has it own currency, it own monetary policy, and its own exchange rate with the euro. Just like Sweden and Norway, to give two geographically close examples, Denmark is independent.

For all intents and purposes, Danish economic policymakers use their independence to shadow the euro, anticipating monetary policy changes at the ECB and holding the exchange rate between the Danish national currency and the euro fixed. Sweden and Norway do not behave in a similar fashion. Their monetary policies tend to shadow one-another rather than the ECB, and their currencies tend to fluctuate against the euro (albeit typically within narrow bands) rather than maintaining a single parity.

This characterization of the three countries has held for much of the euro's existence. The situation changed, however, in October of last year – as the shock waves emanating from the bankruptcy of Lehman Brothers in the United States began to take their toll on European banks and capital markets. At that time, policymakers in the three Scandinavian countries made different choices. The Norwegians and the Swedes choose to lower their interest rates and so cushion the impact of the global tightening of liquidity. These lower interest rates made their national currencies less attractive to foreign investors, and consequently both the Norwegian and the Swedish currencies depreciated against the euro.

Policymakers in Denmark made the opposite choice. Rather than lowering interest rates, they chose to stabilize the exchange rate. This required them to raise interest rates at home even as interest rates elsewhere – at the ECB and in Norway and Sweden – went down. These higher interest rates were necessary to hold onto foreign capital and to maintain the strength of the Danish currency. But they imposed a cost on the Danish economy as well. Hence it is unsurprising that such a large percentage of Danes would perceive their country as acting on it own. In order to shadow the euro, Danish policymakers had no other choice.

This story about the Scandinavian countries can be seen in Figures 4, 5 and 6. Figure 4 shows the evolution of interest rates used for monetary policy and Figure 5 shows the evolution of exchange rates. The break comes in October 2008. This is when interest rates and exchange rates diverge. Since the interest rate story is the most relevant for Denmark (and also the most difficult to see), Figure 6 repeats the information from Figure 4 from the divergence between Danish and ECB policy rates onward.

Figure 4: Main Policy Rates

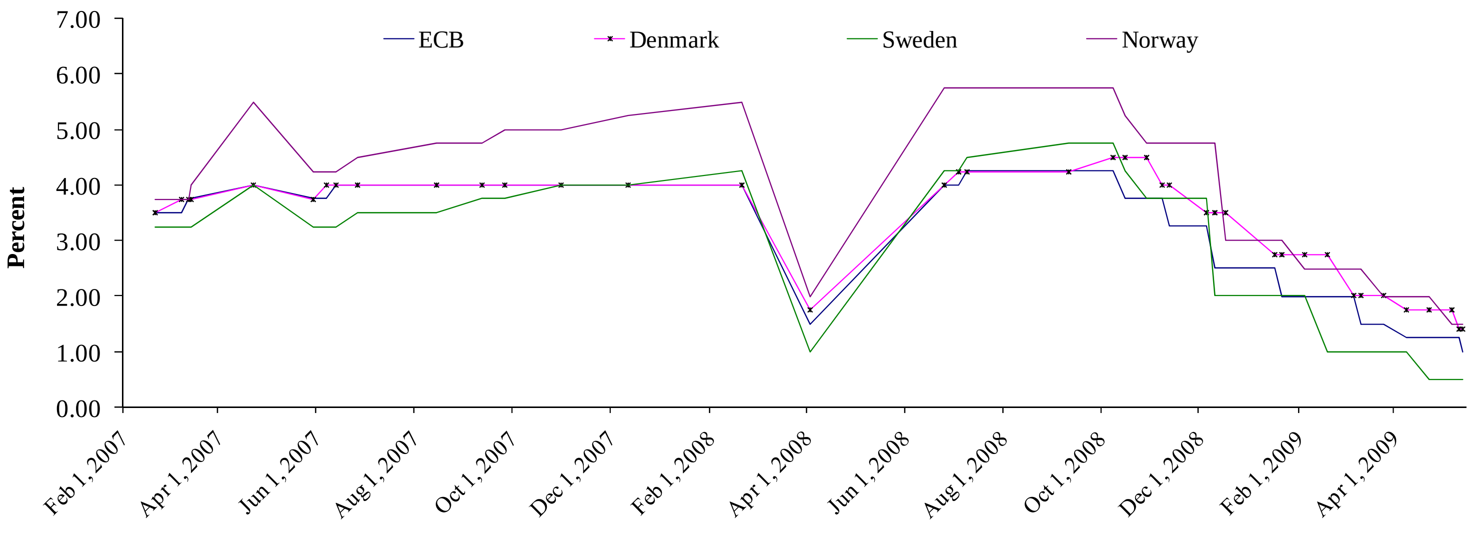


Figure 5: Euro Exchange Rates

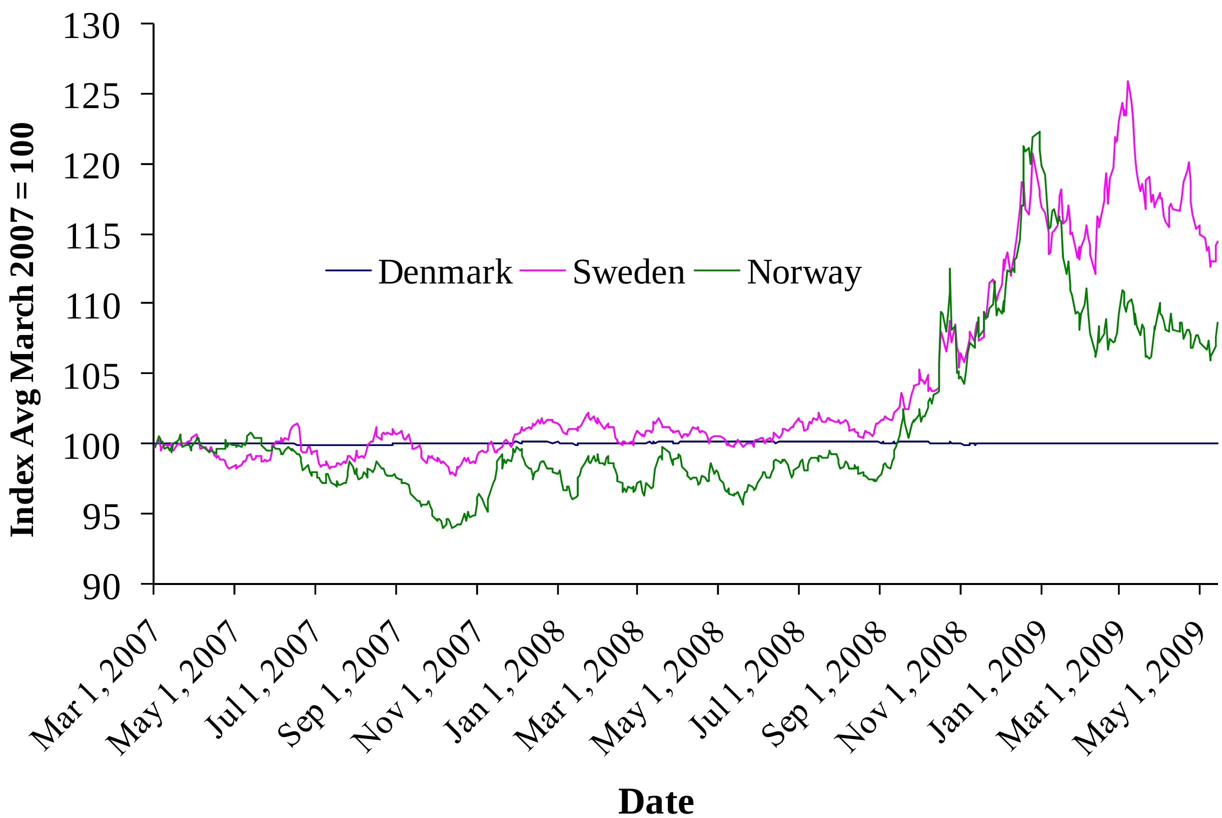


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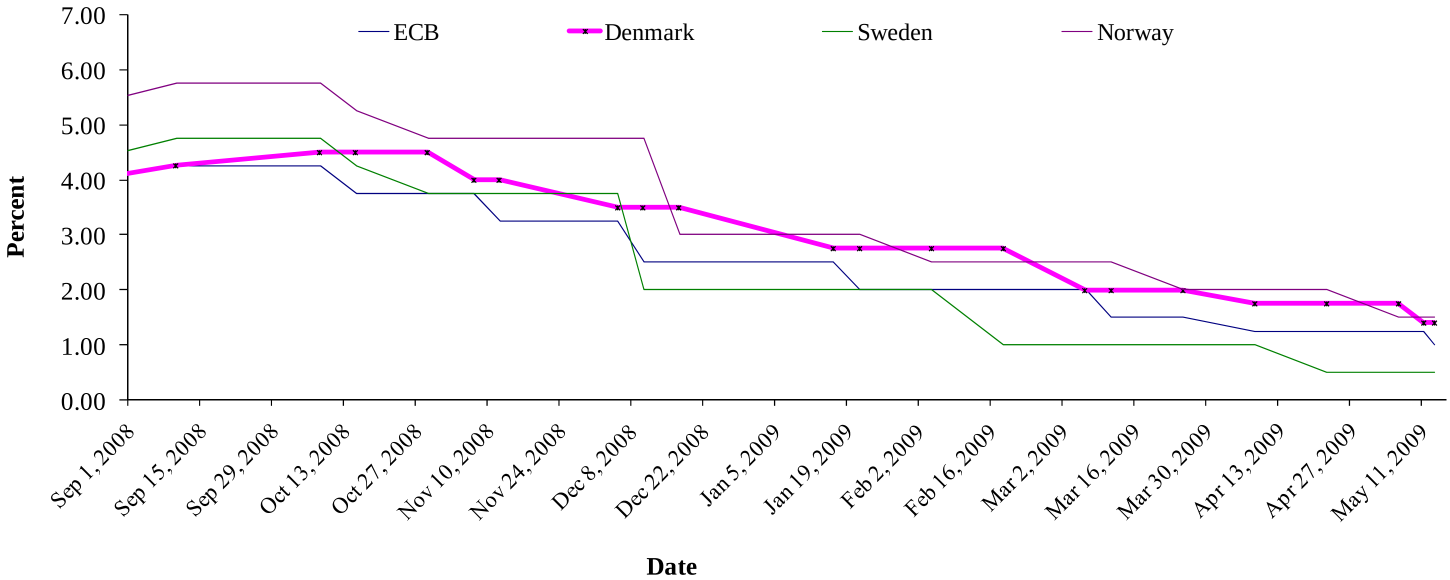
Figure 6: Main Policy Rate Divergence



The situation for Denmark is troubling. The situation for the United Kingdom is worse. The UK is also outside the eurozone and so also has its own exchange rates and monetary policy. Moreover, as the crisis has unfolded, this autonomy has been a large part of the problem. The Bank of England has not had to raise its interest rates against global trends – and, indeed, it has often coordinated its actions with the ECB and the U.S. Federal Reserve. What the UK has experienced is a sudden depreciation of the British pound against other major currencies, combined with an increase in the volatility of relative exchange rates. This can be seen in Figure 7, which provides an index of pound exchange rates against the dollar, yen, and euro from March 2007.

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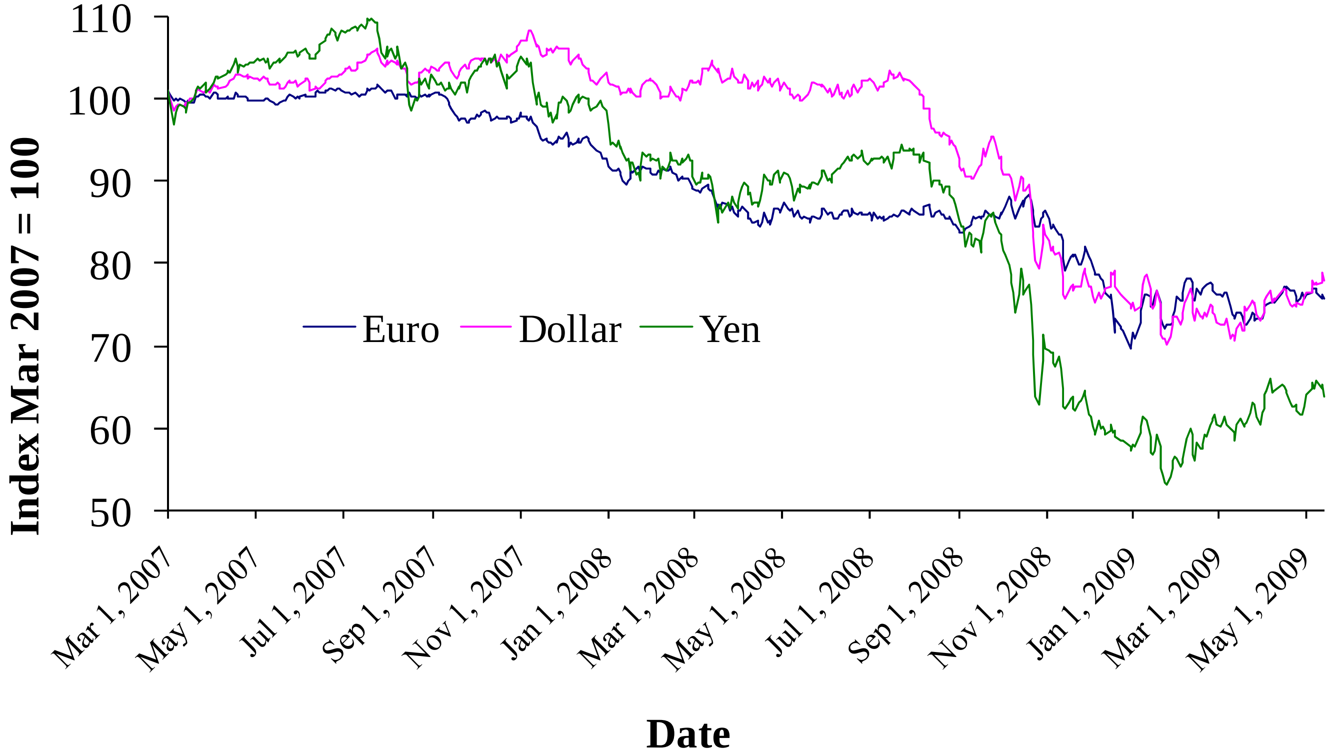
Figure 7: Pound Exchange Rates



The drop in the value of the pound has increased prices for imported consumer goods (like much of Britain's food), and so put downward pressure on incomes even as the economy is slowing as well. Meanwhile the volatility in relative exchange rates has complicated life for the British manufacturing sector – much of which imports from one currency area in order to sell into another. Together with the general decline in the demand for British exports abroad, this volatility has caused total exports to contract by 11 percent in the first quarter of 2009 as compared to the first quarter of 2008. At the same time, employment in manufacturing has fallen off both in absolute terms and – more importantly – relative to total employment. This can be seen in Figure 8, which gives the employment shares of both manufacturing and finance since 1997. The longer time frame is useful because it reveals the extent to which British manufacturing has suffered while finance has prospered since the start of the single European currency in 1999. The current crisis has caused a drop in employment in the financial sector, but it has contributed to the sectoral decline in the relative share of manufacturing employment as well.

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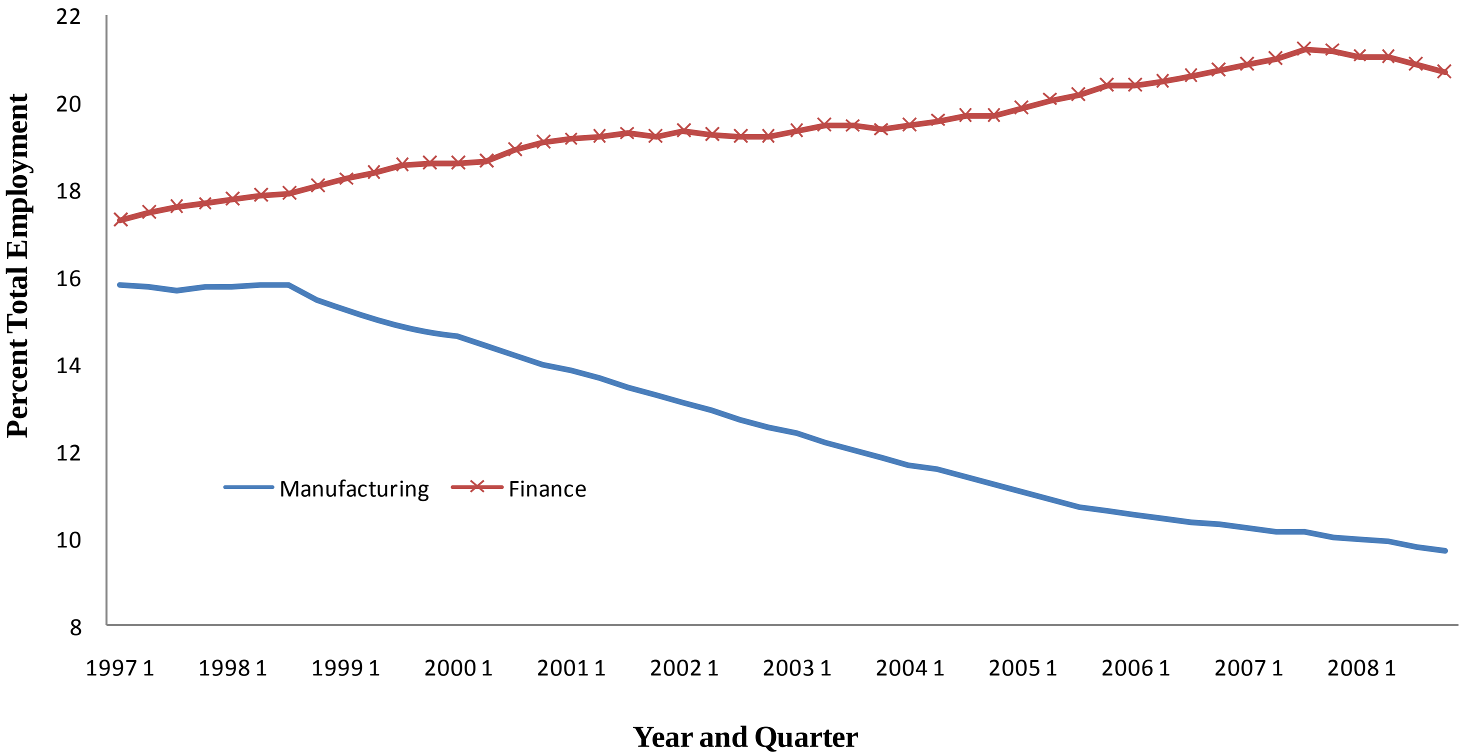
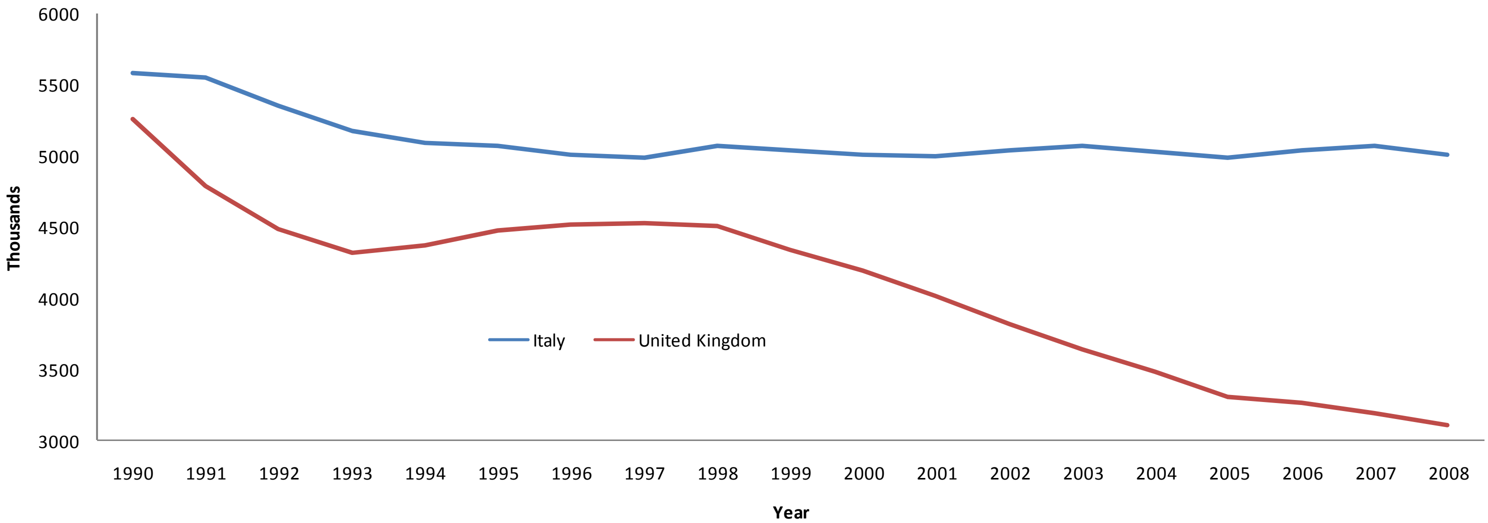
Figure 8: British Employment in Manufacturing and Finance



http://www.statistics.gov.uk

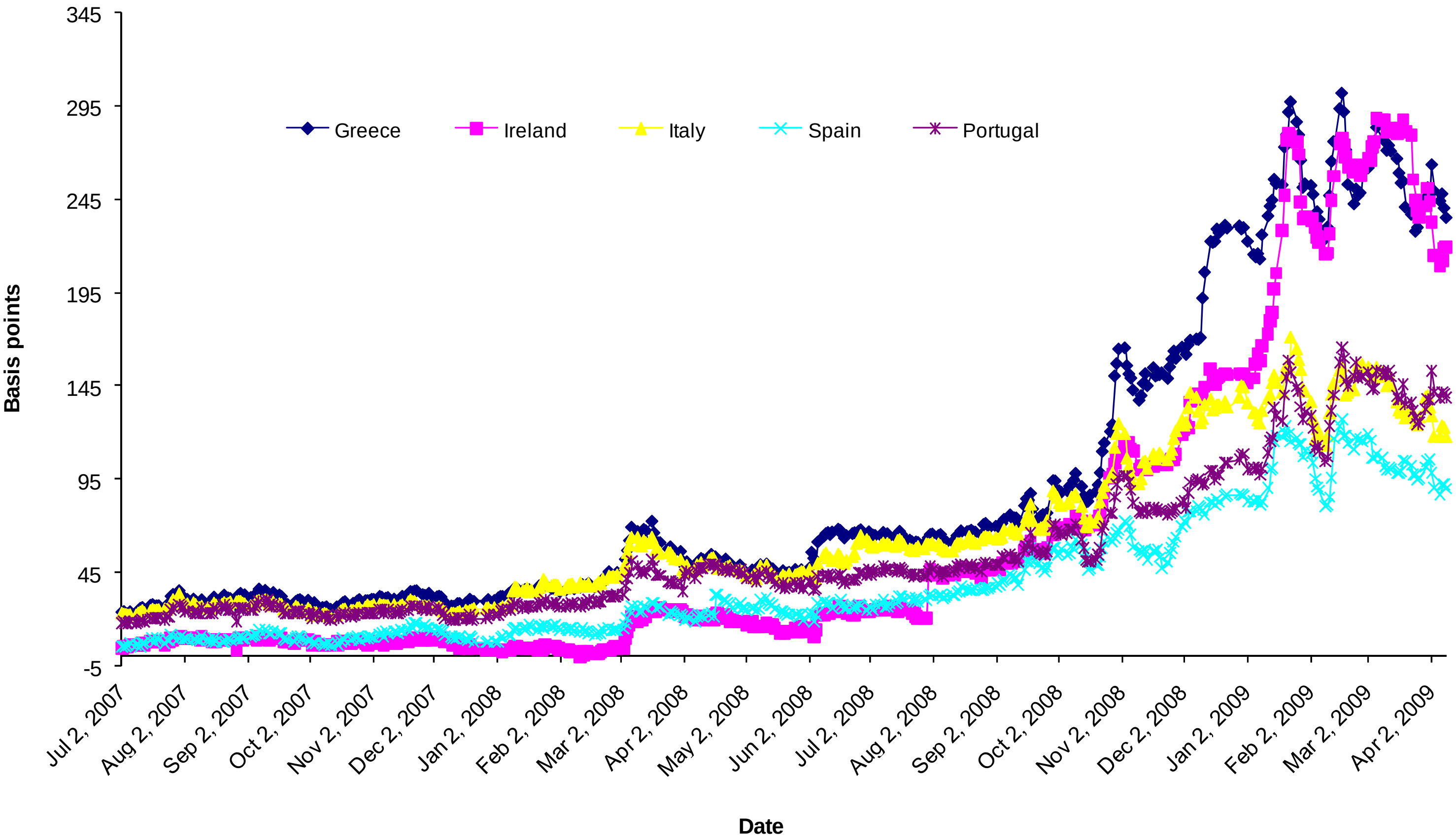
The situation inside the eurozone is better. Employment is suffering there as well, but export manufacturers do not have to contend with volatile exchange rates from one country to the next, and they can rely on deep capital markets to provide liquidity. Here Italy might be a good example. Using a similar data series we can compare the evolution of Italian and British manufacturing employment over the period since 1990. The big change for the United Kingdom comes with the start of the single currency in 1999 – after which manufacturing employment declines continuously. In Italy, by contrast, the level of manufacturing employment remains roughly the same. As a result, there are now just over two million more manufacturing workers in Italy than in the UK.

Figure 9: Manufacturing Employment in Italy and the UK



The stability of exchange rates tells only part of the story. The availability of liquidity is important as well. Consider, for example, the cost of long-term government finance. There has been much concern in the press that the differences between German and, for example, Italian interest rates have increased as a result of the financial crisis. This increase is captured in terms of the differential on government bond yields. And it is true that these have increased dramatically as the crisis has gone on, not just for Italy but for Ireland, Greece and other countries as well. This can be seen in Figure 10, which shows those bond yield differentials. The point to note, however, is that the absolute level of interest paid on government bonds is still much the same as it was before the crisis, and it is much better than before monetary union started.

Figure 10: Bond Yield Differentials



This relative stability can be seen in Figure 11, which shows the actual bond yields. The cost of borrowing may be expensive relative to Germany, but it has been and could have been much worse.

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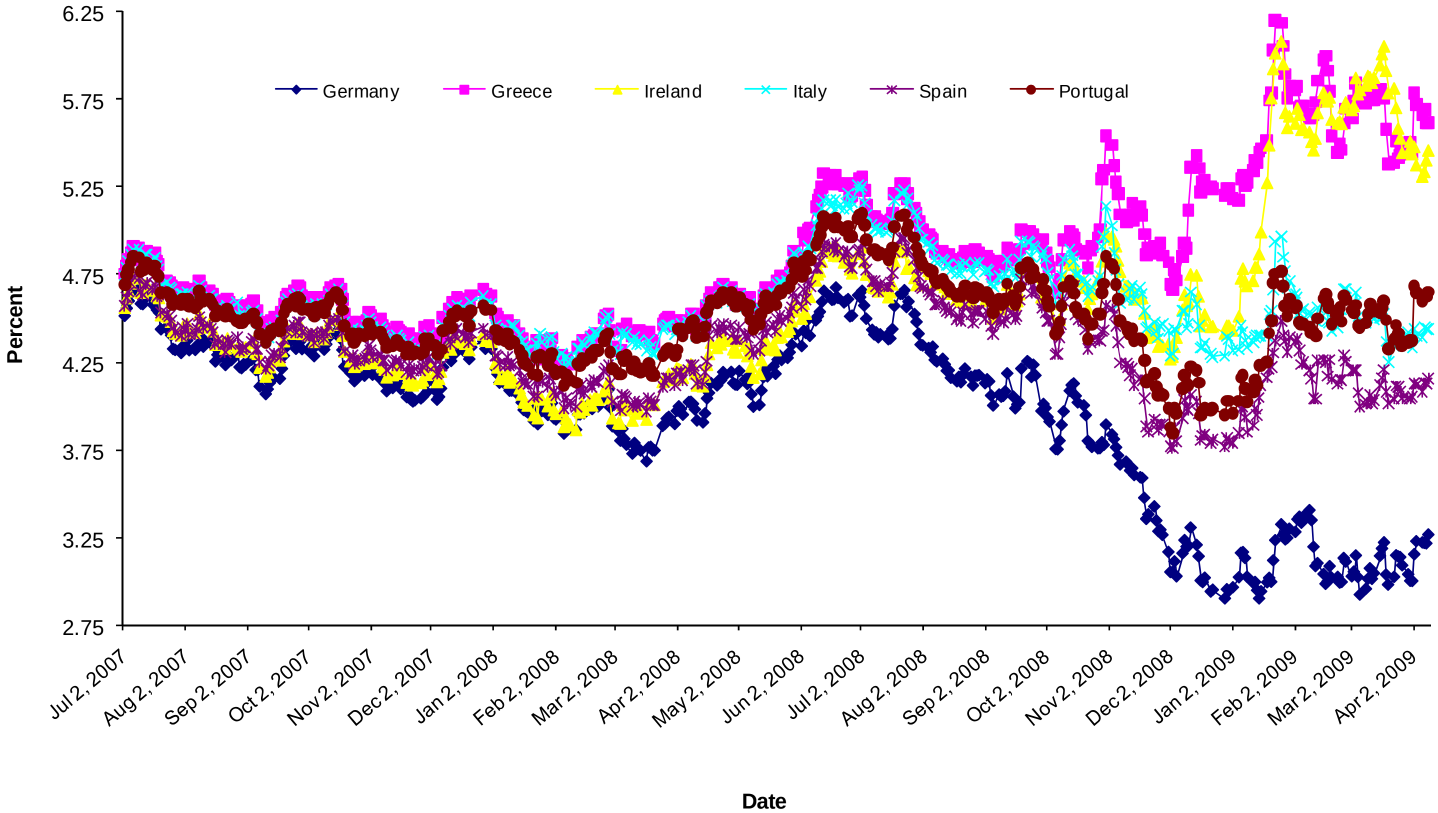
Figure 11: Long-term Bond Yields



Problems with Coordination

Whatever the advantages of monetary integration, however, it is clear that significant problems with coordination remain. Hence, for example, there was no agreement among the member states on a joint stimulus package when the European Council met for its economic summit in March 2009. In its presidency conclusions, the Council "emphasized that concerted action and coordination were an essential part of Europe's strategy for recovery and emphasized that Europe would do all that was necessary to restore growth" but it nevertheless found little to add to the measures already undertaken at the national level.[3] Much of the EURO 400 billion in public sector money being injected into the European economy was already flowing as a result of so-called "automatic stabilizers" – the fall in tax burdens and rise in benefits that takes place during a downturn. The rest was added in a scattered array of one-off measures.

The lack of coordination is worrisome because the European economies are so tightly interconnected. They trade much more within Europe's borders than with the outside world, they follow roughly similar business cycles, and they have a tightly interconnected financial network. As a result, any stimulus money spent in one country is likely to bleed out across all the rest. This makes it almost impossible for national governments to use fiscal spending to give industrial confidence, investment, or consumption a powerful jolt. The European Union does not have the weight of resources to do the job by itself either. The same March European Council considered a proposal to accelerate spending on infrastructure and other large investment projects.[4] And while they did come to agreement, the EURO 5 billion price tag is unlikely to have much of an impact.

The implications of this failure to come up with a coordinated European stimulus package could be seen at the G-20 summit that followed in early April. The Europeans went to the summit with the hope of winning American support for tighter global financial regulations. The Americans went in the hope of achieving a coordinated global stimulus. According to the Eurobarometer polling data cited earlier, both sets of measures would find a wide swathe of popular support. Nevertheless, the Europeans had little by way of stimulus to offer the Americans and the Americans had little reason to compromise in favor of the European agenda. The fact that some European countries – like the United Kingdom – sided openly with the Americans made the prospects for a negotiated trans-Atlantic settlement even worse.

Implications

What is clear coming out of the April 2009 G-20 summit is that more decisive action at the global level is essential to pulling the world's economy out of its current mess. The problem is that such a coordinated response cannot be built all at once. In Europe, particularly, it has to be constructed from the ground up. So far that is not happening and European institutions are suffering a loss of credibility as a result. Nevertheless, there is a clear desire at the popular level to see such coordination succeed. Moreover, that desire extends across a number of different policy areas – which means that it could support a broader global agenda as well. The challenge for Europeans is to recognize and build on the success of their common institutions. Further failure to do so can only make matters worse.

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1. Data in this and the subsequent paragraph come from "Eurobarometer Special 311," (Brussels: European Commission, March 27, 2009).
2. Much of this section is adapted from and broadens the discussion found in Erik Jones, "The Euro and the Financial Crisis," *Survival* 51:2 (April/May 2009) pp. 41-54.
3. See "Brussels European Council, March 19/20, 2009: Presidency Conclusions." (Brussels: Council of the European Union, April 29, 2009, 7880/1/09).
4. "Presidency Compromise Proposal for Financing of the Infrastructure Projects Put forward by the Commission as Part of the EERP." (Brussels: Council of the European Union, March 20, 2009, 7848/1/09).

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