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The Implications of the European Contribution to the Global Financial Crisis for the G-20 Summit

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The story that Europe is telling about the global financial crisis is untrue: The crisis is not simply the fault of the United States. European policies, on both the national and the EU levels, contributed to the buildup of systemic risk that led to the crisis. These policies reduced European competitiveness, led to high levels of leverage at European banks, helped to create property bubbles across Europe, and—through both the Euro and the broader policy of European integration—introduced moral hazard into European markets.

The basic fallacies of European policies are their emphasis on top-down control and their advocacy of a one-size-fits-all model. The policies the EU is advancing for the G-20 summit repeat these errors on a larger scale. Instead of blaming the U.S., Europe should address its lack of competitiveness and growing entitlements burden. Doubling down on centralized control will result in lower growth and a less stable world economy at a time when Europe needs to promote a sustained recovery.

The European Myth. Europe is telling a story about the origins of the global financial crisis. The story is simple: It is America's fault. The BBC reports that the European resistance to stimulus spending derives from its reluctance to go deeper into debt "to rescue the US economy, which they argue was the country that caused the crisis in the first place."[1] The *Economist* concluded in October that the European approach to the crisis was based in part on the "flawed" assumption that the financial system is chiefly suffering from "transatlantic contagion."

The first signs of the current global financial crisis did appear in the U.S. But the collapse of the U.S. real estate market, though important, was merely the first stone in an avalanche. As the *Economist* pointed out, the view that only the U.S. is to blame "fails to take account of…slowing [European] economies…the slumping housing markets in countries such as Spain and Ireland…[and] European banks' dependence on wholesale funding."[2]

The origins of the global financial crash, not surprisingly, are global. Some factors affected some countries more than others, but no country has cause to claim that it was damaged solely by the actions of others. Yet it is those actions that must now face scrutiny. If there is a common theme in the crisis, it can be found in the interaction between politics and economics that created perverse and ultimately dangerous incentives.

The European Reality. In spite of the desire of the EU to pretend otherwise, the European states are very different. Thus, at the national level, the problems these states must confront are not identical. Nevertheless, four features that are present in more than one European state deserve to be highlighted:

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1. *A loss of competitiveness.* European states such as Ireland and Italy have lost competitiveness. In these states, public expenditure has grown faster than private sector pay and productivity. In Ireland, for instance, public spending doubled between 1997 and 2003. This caused inflation to rise two-and-a-half times faster than in the Euro zone as a whole.[3] The loss of competitiveness was the result of government policies that placed excessive burdens on productive employment.
2. *The level of leverage in European banks.* Leverage is the ratio of a bank's total liabilities to shareholder equity. Higher leverage means the bank is doing more business on a relatively narrower base. Leverage can be excessive, but it is not evil—on the contrary, it is necessary for the functioning of the banking system. There is wide debate on the best way to measure leverage. But it is clear that many European banks were more highly leveraged than their American counterparts. A survey by the Centre for European Policy Studies found that the average leverage ratio of Europe's twelve largest banks as of September 2008 was 35 to 1, compared to less than 20 to 1 in the U.S. The survey described Europe's ratios as "a disaster in waiting."[4] Higher levels of leverage do make more credit available and thus reduce its cost. This was appealing in Europe, because cheaper credit fueled growth in its generally sluggish economies.
3. *The European property bubbles.* But this rapid expansion of credit in Europe played an important role in the creation of European real estate bubbles. The IMF has pointed out that, in the run-up to the crisis, "credit aggregates grew extremely fast in the United Kingdom, Spain, Iceland, and several Eastern European countries. As in the U.S., these credit expansions fueled real estate booms. House prices rose rapidly in most of the Eastern and Western European countries now caught in the financial turmoil."[5] The bubbles in Europe were as unsustainable as those in the U.S.
4. *The moral hazards of the Euro and the EU.* These factors speak to the same underlying cause. The years after the Cold War saw high global growth and benign conditions that "fed the build up of systemic risk." As the IMF puts it, "[l]ow interest rates, together with increasing and excessive optimism about the future, pushed up asset prices … [in] a broad range of … advanced countries and emerging markets." The result was a search for yield and the creation of ever-riskier assets.[6]

In Europe, the creation of the Euro was both consequence and cause of that excessive optimism. The case for the currency was always fundamentally political: that it would weld Europe closer together. But the Euro zone is not an optimal currency area. The Euro represents the triumph of politics over economics. It is a one-size-fits-all model for a continent where, in fact, one size does not fit all.

Moreover, the Euro was, in essence, a seal of approval on countries such as Spain, Portugal, and Greece. This encouraged investors to regard these markets as less risky than they in fact were. The admission of many of the now-troubled Eastern European states into the EU also created moral haz-

1. Steve Schifferes, "Papering Over the Cracks at G20," BBC News, March 25, 2009, at *http://news.bbc.co.uk/2/hi/business/7964247.stm* (March 26, 2009).
2. "Lifelines," *The Economist*, October 9, 2008, p. 3, at *http://www.economist.com/finance/displaystory.cfm?story_id=12381995* (March 26, 2009).
3. Garret Fitzgerald, "Loss of Competitiveness Remains Most Serious Issue," *Irish Times*, January 31, 2009, at *http://www.irishtimes.com/newspaper/opinion/2009/0131/1232923379247.html* (March 26, 2009); Wolfgang Munchau, "Is the Italian Economy Really Better Than It Looks?," EURO Intelligence, February 7, 2007, at *http://www.eurointelligence.com/Article3.1018+M55a6aadd587.0.html* (March 26, 2009).
4. Proinsias O'Mahony, "High Leverage Ratios Could Mean Europe's Big Banks Are In Deep Trouble," *Irish Times*, September 24, 2008, at *http://www.irishtimes.com/newspaper/finance/2008/0924/1222205367629.html* (March 26, 2009).
5. International Monetary Fund, "Lessons of the Global Crisis for Macroeconomic Policy," February 19, 2009, p. 9, at *http://www.imf.org/external/np/pp/eng/2009/021909.pdf* (March 26, 2009).
6. *Ibid.*, p. 2.

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ard in the market by encouraging investors to treat these states as if they ranked with the established economies of the West. This approach did not accord with reality.

The False European Solutions. In short, a series of policies—some national, some European—created a framework that encouraged risky decisions by investors and weakened the national foundations on which the resulting bubbles grew. The irony is that Europe is now proposing to double down on these failed policies in response to the crisis.

Europe's call for a global regulator with a mandate to ensure the stability and balance of the world economy would be a tremendous step toward forcing its slow growth model on the rest of the world. Its campaign against "tax havens" is another part of this effort to force other nations to adopt Europe's own anti-growth, anti-competitive tax regime.[7]

These policies are a return to the concept of one size fits all and to the belief that politicians and unelected bureaucrats on the global level can effectively manage the world's economy. Europeans should ask why, if this model works so well, it failed to stop the build-up of systemic risk in Europe. The campaign to blame the U.S. is a form of denial: By refusing to look in the mirror, Europe seeks to avoid facing the unpleasant reality of failure.

This reality includes the fact that the European states are not all alike. Nothing underlines this more effectively that the fact that Germany, having been one of the cheerleaders of European integration, is now reluctant to bear a disproportionate share of the Europe-wide costs of stabilizing that system.[8] From the national point of view, this reluctance makes sense. But it is a sign of the incoherence of European integration that its leading advocate is not willing to pay the bills for the policies it claims to wholeheartedly back.

The True Solutions. It is legitimate to discuss measures that should be taken in immediate response to the crisis. But neither these measures nor the crisis itself should divert Europe from addressing its underlying problems. These begin with its lack of competitiveness and the entitlements burden that, as in the U.S., poses what will in the long term be an unbearable burden.[9] Instead of turning—as it and its trading partners are now doing—to protectionism, Europe needs to move away from the faith in centralized control and the ability of governments to manipulate markets that has brought turmoil to the U.S. and Europe alike.[10]

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7. Ted R. Bromund and J. D. Foster, "The G-20 Summit: Potential Threats to U.S. Interests," Heritage Foundation *WebMemo* No. 2352, March 20, 2009, at *http://www.heritage.org/Research/Europe/wm2352.cfm*.
8. "Commission Tables 200 Billion Euro 'Recovery Plan'," EurActiv.com, November 27, 2008, at *http://www.euractiv.com/en/euro/commission-tables-200-euro-recovery-plan/article-177547* (March 26, 2009).
9. International Monetary Fund, "The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis," March 6, 2009, p. 44, at *http://www.imf.org/external/np/pp/eng/2009/030609.pdf* (March 26, 2009).
10. Elisa Gamberoni and Richard Newfarmer, "Trade Protection: Incipient but Worrisome Trends," World Bank *TRADEnotes*, Number 37, March 2, 2009, at *http://siteresources.worldbank.org/NEWS/Resources/Trade_Note_37.pdf* (March 26, 2009).