Half full not half empty
Europe in the financial crisis

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In the last RECON Newsletter several writers took the opportunity to point out that European performance in the two years of the financial crisis since the collapse of the Lehman Brothers was far from perfect – quite right. It was also deficient in the period before that. But they went on to draw the conclusion that closer integration and better democratic arrangements at the EU level were the answer.

There is a non-sequitur here. The United States has much better democratic arrangements and institutions at the federal level yet it was not only a major cause of the crisis but has thus far had a rather less successful response to the crisis, as it is difficult to get agreement on fundamental changes.

While the EU has ducked some of the harder issues in trying to develop a European level for dealing with cross-border banks, it has addressed the problem of looking at financial stability at the EU level through the European Systemic Risk Board and has achieved remarkable success in putting together a nearly 0.5 trillion euro European Financial Stability Facility. People are very disparaging about the ability of successive Greek governments to face up to fiscal difficulty but it would be an interesting speculation to ask what their standard of living and problems would be now if they had been outside the euro area. The Stability and Growth Pact may not have been as successful in encouraging fiscal responsibility as many hoped but performance since the founding of the euro area has been much better than that of the previous twenty years. Not surprisingly the greatest peacetime downturn in many countries since the 1930s has had serious repercussions.

The financial crisis has emphasised a number of well-known drawbacks to the Western system(s) of capitalism and clearly these need to be addressed and not just in Europe. However, this does not negate the enormous advances that have been achieved in human welfare in the decades since this system has been operating – even taking the crisis and its likely further evolution into account. Of course with optimal policy and business decisions we could be living in a wealthier and fairer society, especially with the benefit of hindsight. But all systems will be imperfect and one of the great features of the RECON project is that it is seeking to

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expose the deficiencies of the present and plausible alternative democratic paradigms for Europe.

One might ask, for example, whether in fact some of the problems revealed by the crisis is that the EU has moved too rapidly towards a single system and that maintaining a flexible exchange rate for some countries might have been more beneficial. In such cases, the more challenged countries can place more weight on the exchange rate as an adjustment mechanism and less on the labour market and fiscal policy. Having more choice at the national level might be preferable. OECD countries outside the EU have seen similar benefits. In many respects a currency area is a fair weather benefit. It gives advantages of lower real interest rates through a lower risk premium and holds down offsetting responses to favourable shocks.

However, there are indeed some important challenges, particularly for welfare in the EU, that the crisis has highlighted. With an ageing population it is clearly difficult to make the fiscal arithmetic add up. For example, in order to make pension schemes viable there has been a switch from defined benefits to defined contributions. Hence people are subject to much more uncertainty. They may not know, even quite close to retirement, what sort of income their contributions will buy as it depends on the performance of the market and the fund managers. Fluctuations in asset values provide a particular problem when history has been largely of rising prices as has been the case in many housing markets. Not only does it pose the difficulty that people are uncertain about how much equity they may have in a house when they need to sell but it makes it more difficult to decide what sort of savings vehicle will offer the greatest protection. Higher expected rates of return are associated with higher risks. However, in the crisis even conservative plans have generated negative returns. Worse still the returns from what appear to be similar risk rated products have varied considerably across providers. It is well-known that past performance by fund managers is not a good predictor of future performance.

This greater uncertainty applies to labour markets as well and European governments have responded to the pressures by a wide range of innovative responses, encouraged by the soft coordination of the Open Method described by Anna Michalski in her latest RECON discussion paper 'Social Welfare and the Levels of Democratic Governance in the EU'. These innovations result in a more complex and flexible system with many providers, which some label 'chaotic' as set out in Tess Altman and Cris Shore's RECON paper 'Social Welfare and Democracy in Europe: What Role for the Private and Voluntary Sectors?'[1]. Organising oneself in the face of a complicated and frequently changing system places considerable responsibility on people.

There is thus an ironic dilemma. Allowing people more freedom of choice may enable them to choose products more related to their specific needs and preferences but it may also expose them to greater risks. It most certainly requires a higher level of financial literacy than a purely prescriptive regime. One of the things the crisis has emphasised is that greater financial awareness is required in the modern world. Financial literacy used to be equated with numeracy but numeracy as taught in schools often has a more abstract scientific framework. It does not teach people how to recognise financial scams or to understand the motivation of people who are giving them advice. Increased financial regulation and harmonisation may help but at the levels of income and wealth prevailing in Europe

[1] RECON Online Working Paper 2010/19.

at present increased financial awareness is also an important ingredient of protecting the more vulnerable.

What does this imply for the three RECON democratic models? Well it does not imply an unambiguous emphasis on a more federal approach. Such an approach may indeed be desirable but the financial crisis does not provide the evidence. Trying to strike a balance between risk management for people and risk management by people at all levels of government faces the modern complex European society with an evolving problem to which there will be only imperfect answers. These answers will not be the same for each part of society nor indeed for each person within it. In the light of such problems the EU has made a pretty good attempt, crisis included. It could have been a lot worse particularly without the degree of co-ordination, co-operation and integration that has taken place.

Unlike some of my colleagues, for me the glass is half full and the wine well worth drinking.