CONFERENCIAS

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HOW CAN EUROPE OVERCOME THE CRISIS?

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I would like to start thanking Confindustria for their kind invitation to share with you some thoughts about the European economy in these times of crisis.

It is a great honour for me to have been invited to participate in this prestigious forum.

I would also like to thank all of you here today for sharing your time and interest with me.

The organisers asked me to devote this presentation to how Europe can get out of this crisis.

And I shall do that because I am a very disciplined person. And I will be clear, as always without beating about the bush.

I will start by referring to the quote that opens this set of conferences. It is a quote by John Maynard Keynes: *“We have to invent new wisdom for a new age….”*

A very well known quote that was written in the thirties when Keynes became a point of reference for the economists.

But let me give you another quote from Milton and Rose Friedman’s widely known work “Free to Choose” written from the perspective of the thirty years which would follow the Great Depression.

“In the realm of ideas, the depression persuaded the public that capitalism was an unstable system destined to suffer ever more

serious crises. The public was converted to views that had already gained increasing acceptance among the intellectuals: government had to play a more active role; it had to intervene to offset the instability generated by unregulated private enterprise…"

In times of financial crisis and bubble bursts; of real estate and financial assets. In times of deep economic slowdown around the world and recession both in the United States and some parts of Europe. In times when the world trade is expected to slow down, an increasing number of voices are heard with catastrophic approaches.

Some consider this crisis to be even worse than the 1929 crisis with some modifications. We are being reminded of events with Wall Street investors throwing themselves out of the windows and American people begging for food along the streets of New York. Some have even said that the fall of Wall Street has had the same effect on Capitalism than the fall of the Berlin Wall had on Communism.

I believe that this financial crisis is not the end of Capitalism. Nor are we facing a new Great Depression.

And let me add that this global recession will only resemble the Great Depression if we make the same terrible mistakes in terms of economic policies that were made at the beginning of the thirties. That is what really worries me.

And I must say that some negative signals have started to flourish in the last few weeks.

The current situation is similar to the 1929 crisis in two crucial aspects. The first one is that the stock exchange market has picketed down. Yes, that's right. Many people have lost money. Yes, that's also right. But a great depression is still a long way off.

It is a proven fact that the changes in the stock market will not reflect the real state of the economy in the short term. Especially in times like these in which the investors are apprehensive, something that prevents them from seeing things clearly.

Having said that, there are six major differences between the current crisis and the one in 1929.

First, bank deposits were not guaranteed back in 1929. When the crisis began, all families ran to the banks to retrieve their savings. Obviously, the banks did not have the money, as it had been lent. That is precisely the banks' business.

They returned as much as they could and when they ran out of resources, they shut down. Millions of people in America lost their savings. Nothing like that is going to happen in 2009, as deposits are guaranteed. The lesson has been learnt.

The second difference is that in 1929 the monetary system was based on the gold standard. That prevented the Federal Reserve from being able to increase the liquidity of their system, because it would have been necessary to increase the stock of metal first

As the gold stock of the Federal Reserve did not increase, it could not issue the money that was disappearing due to the financial bankruptcy. However, in 2008 all central banks are issuing money to inject liquidity into the financial system.

Third difference: there was deflation back in 1929 and the prices and salaries experienced a continuous decrease. That made the family debt unbearable. If someone owes one hundred thousand euros but has a salary of thirty thousand euros per year, that someone can pay. But if the salary is reduced to fifteen thousand euros and the debt is still one hundred thousand euros, then you end up not being able to pay. That made the financial problems of the banks even worse. However, in 2008 no deflation exists.

Fourth difference: In 1929 the US per capita income was six thousand dollars (in current time prices). Today it is over thirty-six thousand dollars. If someone's salary is six thousand dollars per year, a 25% decrease may imply serious problems of access to basics goods.

That same decrease in the per capita income is still a problem with a salary of thirty six thousand dollars but does not involve humanitarian problems. The same can be applied to the second largest economy: the European one.

Fifth difference: the reaction of the United States towards the 1929 crisis was to blame other countries and promote the purchase of American products as well as the taxing of imports. That was the sadly well known duty called “Smooth-Hawley”. Naturally, the reaction of the foreign countries was to tax all American products, what gave way to a trade war which was of no benefit to anyone. Nowadays, despite the many anti-globalisation calls around, no reliable economist would support protectionism as the way out of this crisis.

However, there are indeed some irresponsible politicians. I will address this later on.

Sixth and most important difference: there is something that very few people pay attention to: the return rates of investment within the non-financial sector. In 1929 the tax rate was 0.5%, that is, if someone invested one euro outside the financial sector, the return was almost nought. In 2008, the return of investment in non-financial sectors hit 10%.

This piece of data is extremely important, because even though the increase of the stock exchange market does not lead up to the economic growth of a country, high return rates in the non-financial sectors do.
To be clear: beyond the excesses of Wall Street, Silicon Valley and many other companies around the World, mainly in the US, innovation has carried on, and that it was the economy ultimately relies on to grow.

That means that once the financial agents calm down, and if politicians manage not to force the economic collapse first, capitalism not only will not disappear but will also allow the American economy to walk along a new path of growth.

All that depends on whether the current government avoids making serious mistakes in the implementation of economic policies such as supporting raving protectionism.

Everything I have mentioned here is important to make us realize that this is not the first financial crisis that has taken place since 1929. And above all, we must take into account that despite this being a deep and global crisis, it is very different from the one in 1929. Besides, we can now rely on experience in order to avoid mistakes from the past and take the necessary measures, provided that some irresponsible politicians do not make the same fatal mistakes that were made then.

During the Great Depression, as today, the market was also blamed for the errors made by the Government and by those who freely make decisions in a market economy.

During the Great Depression, as today, those who handled monetary policies failed, as Greenspan himself has finally acknowledged.

Because, ladies and gentlemen, much as it has been said, it should be very heavily stressed that what lies behind the asset bubbles generated in financial and real estate markets is excessive liquidity.

In recent years, most monetary authorities of Western countries finally relented to pressures made by those who, from different political and entrepreneurial forums, claimed for lower interest rates and more liquidity to enable a bigger growth.

As if the key for growth lay in issuing money. All serious political leaders know that this is simply absurd.

But reality is that many Governments, especially in Europe, have lately neglected their responsibilities and have just demanded expansive monetary policies when European economy was already growing at its maximum rate.

Instead of promoting structural reforms, liberalisations, competition, an opening of trade, the rationalisation of the public sector size, the sustainability of the pension systems, reforms of the Health systems, tax cuts and in short, all those things that could increase the potential rate of growth of the European economy, some just chose to look the other way demanding more liquidity. They chose the easiest thing from a political point of view, not the most desirable thing for the country.

Obviously, that does not work.

A part of Europe, a part that is less dynamic and reformist and more statist and rigid in its markets, is going to pay more dearly than anyone for the absence of reforms and the excess of liquidity. Asset bubbles, especially in some countries, are going to demand a high price in terms of low economic growth and rising unemployment.

We are witnessing two types of political reactions to the financial crisis.

Some countries react to the crisis with more public intervention, more –not better– regulation, more market rigidity and more protectionism.

Many countries, aided by political dogmatism, will take the road towards a reduction of economic freedom.

But this is not the only way. There are also countries which have wisely learnt from their mistakes and which will act with pragmatism instead of dogmatism.

These will be the ones choosing to correct the mistakes made by the Governments when handling monetary policy, in its supervising and regulating capacity and with its public policies, including those granting access to housing.

And they will also be the ones strengthening market information and transparency so that shareholders and savers have the appropriate information to assess risks and hire the agencies in which to invest their money.

These countries will probably also add structural reforms to the previous measures leading towards a greater liberalisation, flexibility and trade openness. In short, they will be those that react to the crisis with larger doses of economic freedom.

At the same time, I dare to predict that getting out of this crisis will be a very different matter for both groups of countries. Those choosing the first method, will take a long time to recover, if they do recover in acceptable conditions at all.

The second group, on the other hand, will be the first to overcome the crisis and start growing and creating jobs again.

I think the structural foundations of World economy are sufficiently firm as to be moderately optimist in the medium and long term, once we overcome the unavoidable phase of recession as a result of the monetary and financial excesses made in the recent past. This will, no doubt, translate into a very significant economic and social cost in most parts of the world.

My general optimism comes, in the first place, from the reaction of the central banks. Even if a bit late, they have started to adopt the appropriate measures to avoid the contraction of the monetary supply from emphasizing the crisis of the real economy, as happened in the ‘30s.

Because, paradoxical though it may seem, it is now that central banks must act expansively with their monetary policies. They should not have done so in the past. Least of all, just a few months ago, when the European Central Bank increased its interest rates in the midst of a drastic slow-down of the European economy. A deep and unfortunate mistake.

The aforementioned matters join the decision of the main Western Governments (with the United States at their head) of supporting the banking systems and avoiding systemic crises, which would be lethal for any economy.

My optimism was reinforced by the conclusions reached at the Washington summit held a few days ago, which reaffirmed support of market economy, private property and the Rule of Law. Another unmistakable message of the summit joins these conclusions: an explicit rejection of trade protectionism and the determined support of free trade which should lead to unblocking the multilateral negotiations of the Doha Round once and for all.

A few weeks after this I continue being an optimist, but I have reduced somewhat my degree of optimism.

The reason is quite simple: complying with the commitments of the Washington summit leaves much to be desired.

The first commitment, reactivating the Doha Round, has gone right back to the bin.

Second. Obama's new Administration is sending protectionist messages, which have led the European Union itself to announce possible retaliations to trade.

Third. Some Governments of the European Union member States are returning to protectionist speeches and policies and to giving public funding to the national industry.

This is what worries me most. As I said before, we will get out of this crisis as long as the Governments do not make huge mistakes. Protectionism is a huge mistake and must be banished as soon as possible from political agendas.

Europe has a great new opportunity. Next year will be the tenth anniversary of the approval of the Lisbon Strategy. Ten years ago, Europe decided to lead world economic growth with an ambitious reform agenda. I had the opportunity of leading it, along with Prime Minister Tony Blair.

That agenda was abandoned by many European politicians who preferred to embrace economic naivety instead.

This is the ideal moment for Europe to undertake a new agenda of reforms which supports the opening of trade, market flexibility, reduction of public spending.

Reforms to ensure the sustainability of the pension systems, to improve efficiency and to reduce the cost of health services. Reforms to improve the quality of the Government services as a supervisor, reforms in the financial regulation to strengthen transparency and penalise the lack of entrepreneurial honesty, cutting taxes, a new wave of privatisations, and a reinforcement of

Europe’s energy capacity, renewing support for new generation nuclear energy, clean, safe and cheap.

This is the way out of the crisis. The complete opposite of trade protectionism, of greater and worse Government, of greater and worse public intervention, which some people are trying to bring back to life.

We have learnt much since the ‘30s to give up all that knowledge.