In it together
John Thornhill

This was the week that the US-originated financial crisis was distributed to Europe with a vengeance. With five European banks having crashed in a matter of days and a French budget minister finally acknowledging yesterday that the eurozone's second biggest economy is in recession, the leaders of France, Britain, Italy and Germany will hold an emergency meeting this afternoon in the gilded splendour of the Elysée palace in Paris to discuss their response.

In a letter sent to European leaders on the eve of the meeting, Mr Sarkozy said the European interest demanded an "intense effort of co-ordination". "Our citizens are expecting from us resolute action to protect them," he wrote.

The meeting brings an end to a period of qualified optimism, in which policymakers and financiers expressed quiet confidence that Europe could ride out the storm. Most European countries, they reasoned, had avoided a US-style housing and credit boom - the UK, Ireland, and Spain excepted. Until very recently, the European Central Bank had been more worried about the inflationary effects of resilient growth than the deflationary impact of financial sector contraction.

Yet the latest financial spasm in the US provoked investor panic worldwide over how weaker financial institutions could continue to fund themselves. Within days, Fortis, Bradford & Bingley, Glitnir and Dexia were forced into accepting government bail-outs.

To make matters worse, the latest data across many European countries confirmed there has been a shuddering economic slowdown as businesses have struggled with comparatively high interest rates and a strong euro. The UK, Ireland, Denmark and Spain are either technically in recession or flirting with it. Unemployment has spiked in Italy and France. Manufacturing output has dropped sharply in Germany.

European politicians have rapidly switched from whispering that the situation was manageable to screaming that conditions were worse than anyone could possibly have imagined. Francois Fillon, France's prime minister, won pole position for pessimism by warning that the world was facing its worst financial crash since 1929 combined with the severest economic test since the 1973 oil price shock.

In some respects, Europe is well placed to confront the financial crisis. The European Central Bank has established itself as a credible monetary institution - even if European industry has been screaming for interest rate cuts - and has been agile in providing liquidity to the markets. The creation of the 15-country eurozone has introduced greater stability into the heart of the European economy, ending the frenzy of competitive devaluations that marked previous financial panics.

Europe's governments have shown they can move with impressive speed and efficiency to rescue failing banks with cross-border operations such as Fortis and Dexia. Europe's patchwork system of regulators and financial authorities may not work elegantly in theory, but it has been shown to work effectively in practice.

Yet this crisis is also exposing the flaws in Europe's economy. Angel Gurría, secretary-general of the Organisation for Economic Co-operation and Development, says that devising and implementing a co-ordinated policy response across a 27-country area is inherently far harder than managing a single fiscal, regulatory and political unit such as the US or Japan.

He also warns that the financial crisis's impact on Europe could be proportionately bigger and longer-lasting than on the US. European banks, he says, play a more central role in their economy than do banks in the US, where many "non-bank" financial institutions offer credit. US banks have also been far nimbler in attracting fresh funds to recapitalise themselves.

A Utilização deste artigo é exclusiva para fins educacionais

"In Europe you have a more heavily banked economy. Therefore when the banks are affected by a crisis of confidence you have a proportionately greater problem," he says in an interview with the FT.

Europe's policymakers were alarmed at the fallout from the US authorities' decision to let Lehman Brothers collapse and are determined to prevent such a scenario in the eurozone. On Thursday, Jean-Claude Trichet, ECB president, spoke of the "enormous . . . very unfortunate consequences" of letting Lehman fail.

The lesson, if not stated explicitly, is that politicians should not allow any significant European bank to collapse -and that policymakers should not be hung up on academic arguments over the principle of "moral hazard". Ideologically, European leaders are readier to accept state intervention than their US counterparts. But their big fear is that a far larger and more diversified European bank may now fail.

Dennis Snower, president of the Kiel Institute for World Economics, says Europe must be prepared to inject massive sums into recapitalising the banking industry - as they have done in the US. "The central banks have been acting as the lender of last resort. But we are now discovering that we also need a buyer of last resort for financial institutions that pose a systemic financial risk," he says.

Yet the practical difficulties of saving big financial institutions in Europe are enormous, given that some banks' liabilities are larger than their home countries' GDP. Mr Trichet has cast doubt on the feasibility of creating a European equivalent of the US Treasury's $700bn Troubled Assets Relief Programme. "We do not have a federal budget, so the idea that we could do the same as what is done on the other side of the Atlantic doesn't fit with the political structure of Europe," he said. The lack of a unified regulatory structure and a co-ordinated European response has led some governments to act unilaterally to protect their banks, even at the risk of infuriating their neighbours and distorting the single market. Britain has fiercely criticised Ireland's guarantee for the debts and deposits of its six largest banks.

Writing in his FT blog, Willem Buiter, a professor at the London School of Economics, commented: "The Irish guarantee is the most 'in-your-face' beggar-thy-neighbour provocation since medieval armies catapulted bubonic-plague-ridden corpses into the cities they were besieging."

Several European governments will also be constrained in responding to the crisis by the state of their public finances. Whereas some fiscally virtuous European countries, such as Germany and Spain, can easily increase public spending to sustain demand, others such as France and Italy have little room for manoeuvre. "Saving for a rainy day has to be done in the sunshine. Now it is raining and some countries have very small umbrellas," says Mr Gurria from the OECD.

Perhaps the biggest question in the longer term is whether this financial crisis will strengthen the statism that has been such a feature of the postwar European economy. Critics of the excesses of Anglo-American financial capitalism have certainly been given a boost. Last week France's Mr Sarkozy, who has been a fierce critic of the EU's liberal trade and competition policies, said the crisis had killed off laisser faire capitalism. But he also warned that it would be a historic error to return to "collectivist" solutions.

Franceso Giavazzi, an economics professor at Bocconi university, worries that this new interventionist mood will provide cover for politicians seeking to do "bad" things. He cites the Italian government's intervention to prop up Alitalia airlines while blocking its acquisition by a foreign carrier. "The idea that you spend public money on keeping a local airline alive is a disgrace in my view. If one bank fails it can bring down five other banks and can wipe out established credit relations with other firms. If Alitalia fails no other company fails," he says.

Istituto Superiore Statale "Giovanni Falcone" Fine Educazione Fisica

Further deregulation of the economy and an injection of more US-style entrepreneurialism remain essential if Europe is to raise its growth rate, he argues. "What Europe needs is more, not less, competition."

Fonte: Financial Times, London, October 4 e 5 2008, Primeiro Caderno, p. 10.

A utilização deste artigo é exclusiva para fins educacionais