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Some Lessons for Europe from the Global Crisis

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The 2007-2010 global crisis had a complex character. It started as a financial crisis in the banking sector of the United States of America and grew global due to the intertwined nature of global financial markets. In a sense this was the first really global (not just world economic) crisis. No country or region was exempted from its impact. But more importantly, many of the tensions that broke out in the crisis were generated in global economic systems, one of them being global financial markets. The financial aspect of the crisis was analyzed in sufficient detail and policy efforts have also been introduced to limit the risks of global financial markets (whether they will be effective or not, only the coming few years will tell). Relatively less attention has been devoted to other aspects of the global crisis. Two of these stand out: the excess production common to crises and new ethical problems. Neither of these two issues are completely new phenomena. But like the problems of the financial institutions, they also deserve proper analysis. These two areas are tightly linked and can be analyzed together. Just like the financial system's problems, both have a global nature,.

Not only financial markets have become global, but also production systems. Innovations in production technologies have enabled firms to separate distinct phases of the production process. Production segmentation has enabled companies to concentrate the activities of various factories and affiliates on some core activities and the production inputs in the most advantageous locations. The process went global. Higher specialization and global sourcing increased the cost-efficiency of production. The usage of modular production technologies delivered further cost advantages. The practice of mass customization provided chances to gain economics of both scale and scope. However, just as with previous technological changes in production, increased capacities and output also required increases in demand. Consumption had to increase in existing markets and new markets had to be opened up.

The process of globalization has also helped firms to create demand. However, consumption could be increased only at higher risk levels. Demand stimulation with credits (mostly mortgages) has been in use for over 100 years in the USA. Huge shares of private consumption have always been pre-financed by American financial institutions and the government established support institutions to stimulate and secure mortgage lending. Hence, the demand stimulating (Keynesian) policies of the US government directly contributed to the creation of excessive demand and also to the malfunctioning of financial institutions. In this sense, the initial spark of the subprime crisis was at least partly due to policy failure in the US. But we do not want to go deep into the details of the debate of monetarist and Keynesian fan clubs.

What is important for us is the fact that in the USA but also elsewhere in the world an ever increasing part of private and public demand has been financed by credits and mortgages. While the increase of private and public debt in the US can be regarded as "normal", because global capital markets have been willing to finance it, this does not apply in the same way for other countries and regions. Not all countries and not all economies have the same almost unlimited credibility in global financial markets like the USA. Therefore, not all countries can afford similar indebtedness, or similar demand and consumption stimulation policies. As it turned out in the crisis, not even the USA could afford limitless debt financed demand stimulation. The American economy suffered heavy losses in the crisis. Consumption also declined significantly. Countries with lower levels of credibility and less access to finances suffered even more. Still, most countries have sought to return to the old Keynesian recipe of debt financed demand stimulation. But this is a street with a dead end!

Excessive debt financed consumption is a kind of ethical problem as well. It makes sense to pursue it only if the excess spending is used in ways that produce or improve conditions of repayment. This is a simple rule of thumb. In fact, financial institutions' prudent activity also requires strong control of how extended loans are utilized and adequate knowledge of whether conditions of repayment are sound. It is of course more difficult to control for this on national or global scale. One may argue that even debt financed consumption may contribute in indirect ways to sufficient levels of repayment security. Excess demand creates revenues for firms that can create new jobs, investments, higher levels of productivity, in other words increased levels of production and incomes. However, this indirect effect has been greatly weakened by the process of globalization.

What we can see is that debt-financed consumption contributes to the economic growth of those countries that produce for markets with increasing demand. And this is the exact reproduction of the same imbalances in developed countries that also led to the crisis. European tax-payers money is spent on the promotion of durable goods' consumption in Europe. But much of this production is not European any more. This money has been collected, together with US capital flows, in the huge reserves of the National Bank of China. Neo-Keynesian policies stimulate developed countries' most dangerous economic rivals: the People's Republic of China and some other emerging economies! True, developed countries' firms who are present in emerging market economies also benefit from this spending. And they may even use excess revenues to restore or improve activities in their home country. But this is not very likely since their main drivers are cost efficiency and profits, and they still find better investment opportunities overseas.

But there is also another, no less important, drawback of debt-financed demand stimulation which is also due to globalization. The indirect growth effects described above are also weakened by competing investment opportunities. Globalization also means an ever increasing intertwining of financial markets and the real economy. Firms that are active in various industries and services have invested increasing shares of their assets on the financial markets rather than in their own businesses. Profit margins on financial investments succeeded those in industry by several times forcing companies to invest in more risky, albeit much more profitable financial assets. The role of CFO (Chief Financial Officer) has overshadowed any other position in the largest companies. The shift from core competencies to financial transactions was also supported by the increasing role of financial investors as owners, especially in US-based multinational companies. This process went to the margins in some cases even before the crisis. Big scandals such as ENRON, WorldCom, Parmalat and others signaled the perverse influence of financial investors' expectations and the requirements concerning corporate financial performance imposed upon corporate management. This strong pressure led to unethical management behavior and, in the above cases, to fraud.

But what can be done? First of all most European countries must realize that the conditions for high consumption levels have changed. Europe was not able to maintain competitiveness in several areas. Without the restoration of competitiveness, previous consumption levels cannot be restored. In other words the high living-standards that are regarded by most European citizens as an achievement, to many almost an entitlement, must be curtailed. Dreams of new Member states about convergence to the high levels of welfare in the core of Europe must be put off. However, most European governments do just the opposite and try to restore the shaken bastions of welfare societies by extensively using the tools of debt. They cannot follow this policy endlessly. A decline in welfare, as well as basic restructuring of fundamental elements of the European economy, are unavoidable. In fact, these steps have already been on the agenda for some 20 years. But Europe, with very few exceptions (the Scandinavian model), has not taken these tasks seriously. Core Europe could avoid taking such steps because of the new growth and income generation potential that opened up in Central and Eastern Europe after the systemic change in 1990. But this was a once-off effect.

While basic changes in the welfare systems may require a rather long time (that we do not have), there are opportunities for increasing European competitiveness in the short run. The main concern should be the concentrated development of Europe as a whole. While the management of the troubled budgets of various Member states, as well as the stability of the European currency, must be a top priority, the improvement and development of economic cooperation should also be achieved. The basic direction of the latter should be the establishment and strengthening of a pan-European division of labor. East-Central European economies have become integrated parts of European economic space. Yet, their role has not attained its full potential. Many of the European multinationals have developed their activities in the region by starting with more simple tasks and ended up with some strategic functions. But this process still has unutilized reserves. A deepening of cooperation would increase the competitiveness of all participants. The deepening of cooperation continued during the crisis, new investments were carried out in the region despite the fact that many core European governments introduced disincentives to further relocations. European business seems to have realized further opportunities by tapping East-Central European resources to increase their competitiveness. A growing trend of businesses moving back from more exotic locations in the east to Europe has also been apparent. European business appears to be increasing cohesion and cooperation within European economic space. Governments could support this process.

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