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Which European Response to the Financial Crisis?

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Abstract

The reaction of the European Union to the financial crisis consisted mainly in uncoordinated national plans. A real European recovery plan would have been more effective, but it was not possible because the EU has not a federal budget and a federal government. There are some European public goods – such as monetary and financial stability – which must be supported, in the last resort, by European resources. If the European Union cannot count on its own resources, the stronger States of the Union will be obliged to carry out the role of "lenders of last resort". Moreover, the EU needs a federal government to speak, on equal terms, with the other continental powers. In this essay, it is suggested that the EU should propose to build a "world eco-monetary union" – reforming the IMF in order to substitute the dollar as a reserve currency with the SDRs – to guarantee monetary and financial stability and a sustainable development for the global economy.

Key-words:

Financial crisis, monetary and financial stability, globalization, EU

1. Who is governing the European economy?

In the midst of the financial crisis, on October 21, 2008, the rotating President of the European Union, Nicolas Sarkozy, in his speech to the European Parliament stated that Europe needs an economic government, because "we have endowed ourselves with a currency, a central bank, a single monetary policy, but not an economic government deserving such a name". However, in Sarkozy's opinion, "the true economic government is the Eurogroup, that holds meetings at the level of the Heads of State and government".

In this essay I will try to show that Europe needs a government of the economy, but that government cannot limit itself to inter-governmental coordinations in the Eurogroup. Europe needs a true democratic government, because only a government supported by the citizens' consensus can get the necessary powers – in particular the fiscal and budgetary ones – to cope with the present grave international crisis. In fact, the President of the European Central Bank, Jean-Claude Trichet, in his lucid reconstruction of the financial crisis, has very clearly indicated the limits – and the alternatives – of today's European economic institutions: "the Stability and Growth Pact – he said – is the legal framework we have as a *quid pro quo* for the fact that we do not have a federal budget and a federal government" (Trichet, 2008).

The necessity of a European democratic government is confusedly felt by citizens, due to the hybrid institutional formula used in making European decisions. There are competences, like foreign policy, that are totally dealt with by the inter-governmental method with unanimous decisions, as happens in international organizations. There are other competences, like those regarding the internal market, where decisions are taken by the community method, with the double majority of the Council and the European Parliament. When the co-decision between Parliament and Council has been reached, the Commission acts as the Union's executive, or government. In that case, if the Court of Justice too is included among the Community institutions, the European decision-making process proceeds from a federal core, as was originally conceived by Jean Monnet[I].

Today, the federal role of European institutions is confined to the back seat by a wave of Euro-skepticism. The European public opinion receives a distorted image of European governance. For the citizens, the seeming European government is the one lit up by the mass-media spotlights: the European Council and the sensational statements pronounced by national leaders. However, the other Europe, that of supranational institutions, albeit in the shadow, is the only one able to take common decisions and make them operational, of course within the limits set by the treaties. One could, therefore, reverse the interpretive criterion adopted by political realists, who consider as real the existence of the national States only, and as a superstructure with no autonomy the Community institutions. On the contrary, only thanks to the existence of the European Union could the European national governments hold the financial crisis in check, which otherwise would have swept away the fragile 27 national economies. The existence of a European supranational government does not mean, however, that it also has sufficient powers to efficiently cope with today's challenges. In fact, the study we wish to carry out will concern mainly the powers that the national governments shall entrust to the Union, in order for it to both put in place an effective domestic economic policy, and face the crisis on the international scale. The crisis is world-wide. Not only finance has a global dimension. Also an environment-friendly reform of the economy is a challenge that the European Union will not be able to win alone – likewise the US government – unless it negotiates the necessary remedies in cooperation with the other countries of the Planet.

2. The recent and remote causes of the financial crisis

The recent causes and the developments of the financial crisis have been well described by Alan Greenspan, a non-neutral witness of the crisis. "Global financial intermediation is broken. That intricate and interdependent system directing the world's saving into productive capital investment was severely weakened in August 2007. The disclosure that highly leveraged financial institutions were holding toxic securitised American subprime mortgages shocked market participants. For a year, banks struggled to respond to investor demands for larger capital cushions. But the effort fell short and in the wake of the Lehman Brothers default on September 15th, 2008, the system cracked. Banks, fearful of their own solvency, all but stopped lending. Issuance of corporate bonds, commercial paper and a wide variety of other financial products largely ceased. Credit-financed economic activity was brought to a virtual standstill. The world faced a major financial crisis" (Greenspan, 2008).

The remote causes of the crisis are not mentioned, however, in Greenspan's brief reconstruction. There are at least two of them which date back to the 1970s and 1980s, one linked with the other. The first consists in the resuming of liberal thought, also called neo-liberalism, launched by the economic policies of Lady Thatcher's government in Great Britain and by Reagan's in the USA. A particularly important chapter of the new economic policy was the application of the efficient market paradigm to the financial sector. The less the financial markets are regulated by the public sector, the more easily private savings will find the best investment channels. Entrepreneurs will thus enjoy low interest rates and could start up activities that the banking sector, tightly regulated, would prevent them from doing or would allow at high interest rates. The efficient financial markets paradigm did foster a substantial reorganization of the financial products markets in the US and, indirectly, in the rest of the world. That was a revolution sanctioned by the repeal, in 1999 by the Clinton administration, of the Glass-Steagall Act, approved in 1933 as a remedy against the speculative excesses that had caused the great depression. The Glass-Steagall Act was regulating commercial banks in a different way than investment banks. While the former had the primary function to collect private savings and to loan them according to prudential criteria, the latter could take capital risks by investing in quite profitable activities. Also thanks to the end, in 1999, of the distinction between commercial banks and investment banks, it became possible to extend the variety of new financial products and to increase the credit multiplier in respect to the banks' invested capital. Financial assets were repackaged in groups classified according to their risk level and re-deposited with another bank. In this way, banks were able to rid themselves of their asset-backed securities (ABS), apportioning risks over a wide public and getting fresh money that could be further invested. The illusion was thus created of an almost limitless increase of the volume of loans and of the uselessness of a prudential control by the overseeing authorities, because the efficient market was capable of guaranteeing an almost perfect relationship between securities values and their yield, which included of course a reward for the risk, accurately calculated with econometric methods[II]. The financial crisis has had the secondary effect of discrediting the conceptual bases of the "efficient markets" paradigm.

The second remote cause of the financial crisis concerns the role of the dollar as the international reserve currency. This aspect has not, so far, been adequately highlighted by analysts. The fixed exchange rate system set up in Bretton Woods was replaced with the so-called flexible exchange rate system, but it did not put an end to the use of the dollar as the currency of international commercial and financial exchanges. Therefore, the US currency's *exorbitant privilege* denounced by De Gaulle in the 1960s continued. In sum, the USA could accumulate significant deficits in its balance of payments (its current accounts balance was in recent years higher than 6% of GDP), compensated for by capital flows attracted to the USA by the possibility to get safe interest rates with investments in Treasury bonds or commercial and productive activities. As long as the dollar performs the function of international currency, the countries using it find it convenient, and sometimes necessary, to accumulate a portion of their reserves in dollars. Those dollars would remain unproductive at home, whilst they can yield an interest if invested in US securities. Of course, in order for that situation to materialize, there must be a great amount of dollars that circulates outside the United States, and there must be countries willing to finance with dollars their surplus of current accounts. In the 1980s this function has been mostly performed by some industrialized countries, like Germany and Japan. From the 1990s on, this role has been taken on by some emerging countries, in particular China, which has accumulated, as reserves, an enormous amount of dollars. Such global imbalances (see the *Appendix* for an analysis of the so-called *global imbalances*) have allowed a spectacular growth of the international financial market, but have also generated the illusion of an easy credit, both private and public, in the USA. As to the growth of the credit market, suffice it to note that the derivatives market amounted to 75.000 billion dollars in 1997, about 2,5 times the world's gross production, while ten years later, in 2007, it amounted to 600.000 billion dollars, that is to say 11 times the world's gross production (Minton Beddoes, 2008: 10). As to the US indebtedness, the sum of the public and private debt in the US amounts to 350% of its GNP, while in Europe it is half that (Altomonte, Nava, 2008: 5).

In order to remedy the damages caused by the financial crisis and prevent it from occurring again in the future, it is necessary then to change the rules of international finance, abandoning the myth of the efficient market paradigm; to face the difficult problem of overcoming the global monetary imbalances, and, finally, to relaunch international economic cooperation, averting any instinctive resort to protectionism. These three questions cannot be dealt with by one country alone. The USA is, and will remain for a long time, the preeminent economy on a global scale, but cannot pretend any longer to export financial and monetary rules that jeopardize the entire world economy. All the countries, to a greater or lesser extent, have been hit by the crisis caused by toxic securities. Regulating international finance, the international currency and sustainable development are three aspects that must be addressed jointly.

3. A European lender of last resort without a European Finance Minister

The creation of the European monetary union did not solve the problem of the role of the European Central Bank in emergency situations. The monetary events, in particular during the 19th century, showed that the centralization of the issuing function of paper-money and the control of the volume of credit are indispensable for assuring the stability of a monetary and financial system. Free banking, where it has been tested, has proved to be a failure. However, Art. 105.5 of the Maastricht Treaty leaves the competence of "prudential supervision" to the national level. Only after a unanimous decision can the Council "confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings" (Art.105.6). But that possibility has remained so far a dead letter. The ECB has always asserted, since its institution, the necessity of a European-level supervision. In 2002 its President, Wim Duisenberg, asked to widen the competences of the ECB, but the Council of Finance Ministers refused. However, the recommendations of the Lamfalussy Report, contemplating the institution of European *ad-hoc* committees for supervision, were accepted. But those committees lack powers of intervention due to the simple reason that the rescue or the bankruptcy of a credit institution may require to resort to national public money. Such a regulation of supervision powers is patently contradictory. Tommaso Padoa-Schioppa (2004: ch. 5) observes that financial institutions are more and more exposed to shocks originating beyond national boundaries, while in case of a spreading crisis the infection vehicles produce trans-national effects much bigger than in the past. Few people now, actually, refuse to admit that in the end a single market with a single currency does require a single supervisor, and not just harmonized rules.

When, at the end of 2008, the financial crisis spread in Europe, it soon became apparent that the ECB will thoroughly carry out its role of lender of last resort, but also that the liquidity crisis was accompanied by an insolvency crisis. The British government nationalized Bradford & Bingley. The governments of Belgium, The Netherlands and Luxembourg invested 11,2 billion euros in Fortis; Dexia received an injection of capitals by the Belgian, French and Luxembourg governments. Moreover, the Irish government announced an unlimited warranty for all of its bank deposits. A European coordination of the national initiatives was becoming urgent, and it was suggested to institute a European emergency fund to rescue the credit institutions in difficulties. In fact, the French Presidency of the Union, on the occasion of its convening an emergency meeting in Paris on October 4, with a strange institutional formula (a European G4), hinted at a proposal to eventually create a "European federal Fund" amounting to 300 billion euros. But the proposal was rejected by the German government, so that the crisis of the European banking system went on, until a second meeting was convened in Paris on October 12, this time with all the members of the Eurogroup, and, in addition, the European Commission, the ECB and the British government, which in the meantime had launched a rescue plan for a selected group of the bigger British banks. On that occasion, it was decided that the governments will provide warranties to the main banking groups for their issuing of securities for a five-year period, and that they will participate in refinancing the capital of the banks in worst difficulties. In substance, the idea was sanctioned that they will let no bank go bust. In addition, the level of protection of bank deposits was jointly set at 50 thousand euros, and a commission was instituted for the reform of the supervision system of the credit and financial sector.

These decisions were successful in calming down the markets and in reassuring the savers. In the following days, the governments announced a series of national intervention plans for a total of 1.873 billion euros (the US plan amounted to 700 billion dollars), about 15% of the European GDP (EU-15). The European governments, acting in a concerted way, have thus succeeded in checking the acute phase of the crisis, but at least two considerable breaches of the European institutional structure have emerged. The first concerns the resorting to national aids to the banks in difficulties, in contrast with the

Treaties' norms forbidding State aids, unless authorized by the Commission. Of course, the Commission stepped in, ex-post, but it is certain that the national governments will exploit any possible means to help their enterprises. It may be a disguised return to national protectionism. If such violations become systematic, the principle of the single market will be put in question. Secondly, the lack of a European Finance Minister (and of an adequate Community budget) has represented a power-vacuum that jeopardized the survival of the monetary union, and an excuse for resorting to massive national interventions, probably much higher, in their totality, than the amount of an efficient European-level insurance.

Now the discussion has begun on the reform of the European supervision system. The Belgian Prime Minister Leterme (2008) asked for the institution of a European Fund, subsidized by the EIB. "At the end of September – Leterme observed – the Belgian financial sector was shaken by a serious crisis. Fortis, our main bank, Dexia, the third-biggest, and an insurance company have been hit by the consequences of the international financial crisis. These institutions own activities equivalent to about three times the Belgian GDP, and the value of their deposits is higher than the national income". Belgium would thus not be in a position to cope, alone, with a second crisis. The call for a European Insurance Fund seems to be founded on sound reasons and other experts too (Gros, Micossi, 2008; Lanoo, 2008) support it, together with the proposal to institute a European system of financial supervisors based on the model of the European system of central banks, keeping a tight coordination between European and national authorities.

These proposals do go in the right direction, but they try to sidestep a structural problem that concerns both the supervision of the credit and financial market[III], and the entire economic policy of the European Union, namely Europe's budgetary powers. Financing the European Fund through the European Investments Bank represents a screen behind which the question of the financing of the European fiscal resources comes up again: if a banking crisis will occur again, which political authority will in the end authorize the interventions? The resources of the Fund could be used by all the countries or by some of them only? A European public good – like the stability of its monetary and financial system – must be assured by European fiscal resources. In fact, some economists have come to this logical conclusion (Schinasi, Texeira, 2006). The solution to the problem is simple. There must be a European budget, financed by own resources, the management of which is entrusted to the European Commission, responsible before the European

Parliament. The European budget should contemplate a heading for urgent and extraordinary interventions[IV]. The use of funds in emergency situations should be decided by the Commission – at the request of the European Finance Minister – after seeking an opinion from the ECB and the supervising body. The Commission shall be accountable of its decisions to the European Parliament. This reasonable procedure has never been seriously considered so far, because it is at odds with the taboo of fiscal sovereignty, which governments want to keep among the exclusive national competences.

4. A European Keynesian plan with national fundings

The dangers of the financial crisis and the instinct of survival drove the European governments to ditch their deep-rooted prejudice against supranational Keynesian policies. To understand the situation – partly produced by the prevailing academic doctrine of the last decades, focusing on the priority of the supply policies – one has to go back to the Maastricht compromise of 1991, when it was decided to make a monetary union without increasing the Union's budgetary powers. The Stability and Growth Pact, agreed in 1997, transformed the compromise into a Treaty that was forcing the national budgets to abide to some fiscal parameters. Moreover, it is worth recalling that the Pact was conceived in order to assure the “monetary and financial stability”, and the word “growth” was added at the last minute for silencing those who would have liked less rigidity. The non-explicit meaning of the Pact is that fiscal policy and growth must remain strictly national competences. The European Union deals with growth, development and employment only from the viewpoint of coordinating the national programs. Jacques Delors, the Commission President who carried the Maastricht Treaty through, was the first to realize the deficiencies of the compromise, and tried to remedy by proposing in 1993 a Plan for “Growth, Competitiveness and Employment” (CEC, 1993) which should have given a long-term impulse to the European economy, allowing it to create by the year 2000 more than 15 million new jobs through a series of structural investments in trans-European networks, in information technology, in research, in education, in professional training. It is interesting to observe here that the Delors Plan was contemplating an overall annual expenditure for the period 1994-1999 of 20 billion ECUs (euros), or about 0,33% of the

European GDP, of which 5,3 charged to the Community budget, 6,7 provided by the EIB, 7 financed by Union bonds and 1 billion by bonds secured by the European Investment Fund. It was, in essence, a plan with investments addressed to increase labour productivity and the competitiveness of the European economy, hence aiming more to stimulate supply than to support demand. In any case, the Council of Finance Ministers (Ecofin) soon took it upon itself to bury the project, refusing to provide money to it, despite the support of the trade unions and the European Parliament. Only in 2000, after years of difficult growth, in particular if we compare it with the vigorous one of the USA, was the so-called Lisbon Strategy launched, which is completely based on the philosophy of the Stability Pact, i.e. it gives the Commission the mere task of coordinating the national plans: growth is dependent on the impulse provided by the governments of the member States. This strategy proved to be a failure. The national governments pursue national, not European priorities. The European economy continued to devote scant resources to research and innovation, to have high unemployment levels and a low level of public and private investments.

The recent Commission plan "A European Economic Recovery Plan" (CEC, 2008), approved by the European Council on December 11-12, 2008, differs from the Delors Plan since it does not aim to have a sustained growth in the medium-long term, but "to inject purchasing power into the economy, support demand and stimulate confidence". It is a "macro-economic, anti-cyclical", short-term plan: its effectiveness should be tested in the course of 2009, and the programmed financing covers the two-year period 2009-2010. Its total amounts to 200 billion euros, equal to 1,5% of the European GDP, of which 0,3% charged to the European Union and 1,2% to the member States.

The European share of the plan (0,3% of GDP) is innovative because it is a complement to the second project approved by the European Council, the "energy-climate package 20-20-20", i.e. the commitment to reduce greenhouse gas emissions by 20%, to reach the 20% level of renewable energies and to save 20% of energy by 2020. The Commission plan provides a series of investments whose purpose is not only to make the European economy more competitive, but also to "green the economy", transforming it into an economy at low consumption of carbon dioxide, thanks to an increase of energy efficiency, to energy saving and to the introduction of clean technologies, in particular in the building and automotive sectors. The social aspects of the plan concern the creation of new jobs and the protection of jobless workers through a strengthening of the European Globalization Adjustment Fund and the European Social Fund. Special terms for financing and supporting innovation are provided to small firms. In addition, it was decided to start up a "2020 Fund" for energy, climate change and infrastructures ("Daisy Fund") which will co-finance, together with national institutional investors, some innovative projects.

There is now to express some criticism of the Plan for the recovery of the European economy. The European financing of the plan is almost entirely entrusted to the EIB, which is authorized to issue bonds 30 billion euros worth in the years 2009-2010. The other grants come from already allocated money in the Community budget (however, 5 billion euros are taken from unspent sums that should have been distributed to the member States). The rest of the plan (about 170 billion euros) should be financed by the member States themselves, who have pledged not to exceed the limits imposed by the Stability Pact. Consequently, not all of the countries will be able to contribute with the same effectiveness to the economic recovery. Countries like Germany, with balanced accounts and a low public debt, have a wide margin for maneuver. Countries like Italy and Greece, heavily indebted, will hardly be in a position to contribute to support Europe's aggregate demand. In fact, a first estimate tried by some economists (Saha, von Weizsäcker, 2008) of the overall volume of the plan's fiscal impulse in the year 2009 gives a figure of 0,64% of the Community's GDP, while it reaches 1,18% if also the credit-related incentives are taken into account. Secondly, there is to note that if the part of the plan financed by national investments is high, free-rider behaviors will be encouraged on the part of some governments that, without formulating any national plan, expect to reap the benefits – given the high level of integration of European economies – deriving from the incentives to aggregate demand in other countries. The remedy to that drawback is simple. It would suffice to increase the percentage of European expenditure to 50% or more, ruling that the European investments be co-financed for the remaining amount by national resources. Should the European coordination be ineffective, the national plans will result inconsistent with each other and the sum of the national incentives to growth will be lower than the European incentive to growth produced by the same level of expenditure[V]. Thirdly, there is to observe that the part financed by European resources is kept small, probably due to the governments' refusal – expected by the Commission – to finance it by issuing Union bonds, as was provided for in the Delors Plan of 1993. Fourthly, the less-virtuous countries will be forced to obtain money from the financial market, at less favorable conditions than more virtuous countries will get, whilst a more efficient European plan would have shared more equitably the costs of its financing. Finally, as our fifth observation, if the part financed by European resources is small, the old doctrine – that growth is led by "locomotive economies" like Germany – will prevail in the end. This is a serious snag, because it encourages on the one hand free-rider behaviors in some countries, and on the other it drives "virtuous" governments to refuse to pay for other countries too. In sum, the scantiness of European resources feeds national selfishness and produces effects liable to bring about the failure of the entire project.

Even in this case, as in the one before regarding the institution of an emergency fund, the decisive obstacle to the effectiveness of a European intervention derives from the non-solution of the fiscal problem. The European Union should use own resources. However, this is an abstract principle, proclaimed in the Treaties but disregarded in practice. A substantial part of the European budget, more than 70%, is financed by national contributions, and the governments require that the budget shall not be higher than 1% of the Community's GDP. The European budget, which must be in balance, is seen as an appendix to the national budgets, not as an instrument of the European economic policy. That is why the additional financial resources necessary to cope with the economic crisis have been obtained through the EIB, a body subordinate to the national governments. But in this way, the European Parliament and the Commission are deprived of a margin for maneuver that would allow the political parties and the citizens to contribute with their proposals to establish the guidelines of the European economic policy, including its relative importance with regard to national economic policies. The cost of Europe's bad governance is a disjointed Union, unable to carry out efficient policies.

5. Which European proposals for a new world economic order?

The criticism just addressed to the European plan for economic recovery concerns its internal coherence. There is a more general aspect to consider, to evaluate its effectiveness: the financial crisis has had global effects, because it is causing a sizable decrease of world trade and production. Any partial plan, even covering economies of continental dimensions like those of the USA, the EU, China, Russia, etc., will not be effective unless the problem is dealt with in its global dimension. We limit ourselves to two considerations. The first regards the depth of the financial crisis and its duration. However much past history can provide lessons for the present, banking crises occurred after WWII show that the drop in real estate and share prices lasts for several years, that the drop in employment reaches levels higher than 7% of the average, and in the production sector even 9%; finally, that public indebtedness can reach levels 80% higher than the present ones, because governments try to limit through fiscal policy the harmful consequences of the crisis (Reinhart, Rogoff, 2008). These average values apply to crises occurred in one or more countries, but not to a global phenomenon, barring the Great Depression of 1929. There are then reasons to fear that the consequences of today's crisis may be much more harmful than those of the past. Secondly, the internationalization process of the economy, even if it was ill-regulated, did allow for the establishment of a division of labor articulated among numerous countries. The dense worldwide network of the production system is accompanied by an indispensable macroeconomic organization, which depends on the consumption and saving styles of populations, as well as on the role of the State in the economy. In the course of time, international macroeconomic relationships are built, concisely revealed by their respective balance of payments, among countries with a surplus, i.e. with exports greater than imports, and countries with a deficit. If the world's aggregate demand is expanding, international trade grows, consumption and investments grow, and the countries with a deficit can count on capitals coming from the countries with a surplus. But a harsh crisis can upset the picture. Countries with a surplus, like Germany, China, Japan, etc., will see foreign demand of their products decline. Countries with a deficit, like the USA, Turkey, South Africa, etc., risk suffering a drastic reduction of the financial flows coming from the countries with a surplus, now engaged in supporting their own internal demand. Internal fiscal policies aimed at relaunching demand are necessary, but they risk being a palliative, because every country will try to use public money to support domestic production and employment. The US government will support the US automotive industry, not the European automotive production; the European Union will do the opposite. The result will be that some enterprises will survive only thanks to public subsidies. In other cases, countries will try to stimulate exports by devaluing their currency. The fabric of international division of labor will get torn in many places and world productivity will be reduced. The world will become poorer, on average. In addition, the strategy of the locomotive countries which draw the world recovery will not have many chances of success. Some economists reckon that an eventual US plan of the size of 5-6% of GDP will not succeed in filling the deflationary demand gap in the USA (Godley et al. 2008). The summation of a series of national expenditure plans, in which the investments aimed at stimulating national employment are favored, provides a production increase (thanks to the Keynesian multiplier) lower than what is possible to obtain with one expenditure plan coordinated on a world scale (Montani, 2008: 186-191).

The political and social consequences of this foreseeable long depression are worrying. Unemployment will grow, social protests will increase, migratory flows will be hindered, measures will be taken to protect national production, as refusing imports (which steal jobs), and to seize other people's aggregate demand, by devaluing one's own currency. The emerging countries will see their hopes of development fade away beyond the horizon. Everywhere, nationalist, populist and xenophobic movements will become stronger.

The question of a European government cannot, therefore, be limited to the aspects discussed above. A government is also instituted with the aim to support the interests of a political community in world politics. In fact, the European Union, aware of that necessity, has pressed for a worldwide reflection for a new Bretton Woods; it supports the resuming of trade negotiations in the framework of the Doha round, and is preparing itself for the after-Kyoto, as far as the fight against climate change is concerned. However, it is necessary that the European Union gives itself a consistent strategy for the reform of the international economic order and speaks with only one voice in world conferences. These two requisites are lacking, at the moment.

Let us consider the first problem. People say that the international organizations created by the USA after the war are inadequate, but it is not clear in which direction we have to proceed for reforming them. The international organizations did function, although with many limits, mostly thanks to the US hegemonic power assuring some indispensable international public goods, like security (at least for the western world), freedom of exchanges and international monetary stability. Without those public goods an international order degenerates into anarchy. Today, the same public goods must be guaranteed by other institutions, without an hegemonic power, because it is not thinkable that one country, however important, can cope with the planetary challenges of the 21st century: an agreed action is necessary, to be shared with emerging powers like China, India, Brazil, as well as the European Union, the USA, Russia, Japan and the smaller countries that want to participate in the management of world affairs. In other words, a multipolar world can be built, where a peaceful management of interdependence is realized. The crucial problem of the 21st century is, in fact, to reconcile peoples' independence with their interdependence.

Europe can give a significant, perhaps decisive, contribution to the building of a new world economic order. The European integration process was initiated to solve a problem similar to the one the world must face today: assure peace in Europe, in the first place between France and Germany, through the creation of supranational institutions, with powers limited to the economy (the European Coal and Steel Community), but real. Today the European Union should promote, on the world scale, the creation of institutions providing supranational public goods: monetary and financial stability, ecological reform of the economy, trade cooperation for the development of emerging countries and, finally, international security. In the management of these worldwide public goods all the countries should participate with equal powers, independently of their wealth and size. The only requisite shall be to underwrite a Pact where the mutual rights and duties are specified. In sum, Europe should propose a *World Eco-monetary Union*, where “eco” is an abbreviation of both economy and ecology, because those two dimensions of human activity are today tightly connected. The difference between the project of a World Eco-monetary Union and today's international organizations consists in the granting of real supranational powers to the World Union. The EU should propose to institute a World Central Bank, with the power of controlling global liquidity and of prudential supervision. The World Union should have a system of own resources – necessary to save the bio-sphere from environmental deterioration and to assure prospects of development to the poorer countries. If the establishment of such a first world-wide common home will be accepted, and sufficient powers will be given to it to promote common policies of solidarity and development, then confidence will be restored in the production and finance markets. New and stable rules of behavior are indispensable for economic operators to resume to weave the fabric of international division of labor that the present crisis has brutally torn. In this perspective, the more sensitive and complex problem of military security could be postponed to when the desire of peaceful cooperation will be consolidated, as happened in Europe after the initial stages of the integration process.

In the World Eco-monetary Union project, the currency question takes on a particular importance, because the financial crisis and the presence of a currency, the euro, alternative to the dollar as reserve currency oblige to seek a solution that cannot be limited to the mere working out of new rules for international finance. Who will decide on the new rules? And who will watch over their observance? Monetary and financial stability represent the hinge around which multipolar integration can develop. Failing to solve that problem in the globalization era would create the premise for an even worse crisis than the present one (e.g. a crisis due to lack of confidence in the dollar). It is necessary to replace the present asymmetrical monetary system with a symmetrical system, in which the currency can be considered as a global public good. The key currency of international exchanges, which is today a national currency, must be replaced with a currency controlled by supranational institutions (for a more in-depth analysis, see the *Appendix*).

Finally, the European Union must speak with only one voice in those negotiations. The European Union has already partly created the institutional structure that allows it to present itself united on some problems. On trade and ecology, it is the European Commission that acts as the European government in international conferences. After the creation of the European currency, it is just an obtuse reluctance by the national governments that prevents the Union from presenting itself united in the IMF or the World Bank. Should the Union have an autonomous budget, a Finance Minister and a "Prime Minister", it could speak in the negotiations for a new international economic order as equal to the other world governments.

6. The European Union's twin deficits

The hybrid nature of the European Union has spurred a lively debate among academics about how to classify an "unidentified political animal". The European Parliament defined the European Union as a "supranational democracy". That is more an aspiration than a reality. Actually, the European Union suffers a democratic deficit, as shown by the repeated attempts to reform it and the efforts by the Commission and the

Parliament to bring the citizens closer to the European institutions. The presence of a seeming European government (a governance) that is unable to take decisions except in the framework of existing supranational institutions, fuels confusion and disunion. The national prima-donnas turn up on the European stage only to collect rounds of applause. But it is the beams supporting that stage that shall be brought to light. The citizens must be in a position to judge who is making the decisions and sanction them with a negative vote if they make mistakes.

In turn, the democratic deficit turns into a governance deficit, because in the absence of an adequate budget, as we saw, the Union's policies are inefficient: their realization depends on the case-by-case consensus of the national governments. Germany's complaints – "we do not want to pay to solve other people's problems" – are understandable, but unreasonable. European public goods must be financed by European own resources. If the Union's budget is not sufficient, it is inevitable that a few national governments must, sooner or later, take upon themselves a European collective problem. If adequate resources are not granted to the European budget, the monetary union will run a serious risk of disintegrating. It is not a matter of imposing a further fiscal burden to the citizens, but to better distribute the fiscal resources between the national and the European levels. Only by applying the principles of fiscal federalism can this problem be tackled and solved. The Stability Pact is a bad substitute for a federal budget and a federal government.

The remedy to the twin deficits – of democracy and of governance – is simple: it is necessary to abolish the veto right in the Council of Ministers, which would thus become the second Chamber of the Union (the Chamber of the States) beside the European Parliament (the Chamber of the people of European nations). Once the principle of legislative co-decision is accepted, the European Commission will automatically become the only executive of the Union, also in foreign policy, if there is the will to do so. The deficits are two, but the remedy is one. More complex solutions, like a stable Presidency of the European Council, or a Directorate of the most important countries (as Sarkozy would like), represent palliative measures aimed to avoid to face the fundamental question: the abolition of the veto right.

Appendix

Global imbalances and the World Eco-monetary Union

The debate on the regulation of financial markets and of the economy is intertwined with that on the international monetary order because, since the Asian crisis of 1997-98, it became apparent that the crisis of the balance of payments is often accompanied by a crisis of the banking sector. The recent financial crisis, which originated in the United States, did not turn into a currency crisis because the dollar is the key currency in international payments. But if solutions applicable to all countries, including the emerging economies, are to be found, it is necessary to also consider the problem of monetary stability.

The seemingly simplest alternative is to go back to the control of international capital movements (e.g. by introducing a Tobin Tax), as was the case in the period just after the war. However, although the debate on the effects of international capital movements on economic growth did not lead to concordant results among economists (Eichengreen, Leblang, 2002; Obstfeld, 2008), one cannot but observe that the development of many Asian countries, in particular the Asian Tigers, China and India, was accompanied by an inflow of abundant capitals from abroad. Only in the context of a nationalist and Luddite policy would the idea to limit or stop international capital flow have any sense.

The free international circulation of capitals is still little understood in economic theory, that studies international trade with the theory of comparative advantages, without integrating it with that of monetary unification. It is possible, on the contrary, to demonstrate that in a commercial and monetary union, where labor and capital circulate freely, it is possible to attain labor productivity levels higher than in a situation of just free international trade (Montani: 87-94). The experience of the European integration is meaningful: after the common market, which allowed the free circulation of goods, a further progress has been made with the single market project in 1992 – later improved by the EMU – which consisted in the free circulation of people, capitals and services. Today, globalization may be interpreted as a stage in the integration of the world market, where, after the almost complete abolition of tariff barriers, the free circulation of all production factors is spreading.

The integration process of the European market has been brought to completion with its passage to the monetary union. An objective of the same importance must today be considered on a world scale. To show the necessity of it, let us consider the question of world imbalances caused by the use of the dollar as the international currency. Ben Bernanke (2005), the Governor of the Fed, argued about the existence of a global saving glut. After the Asian crisis of 1997-98, many emerging countries have chosen to peg their currency against the dollar, and, in order not to run further risks of sudden flights of capitals, have piled up big amounts of reserves, thanks to their surplus of current accounts. The United States, on the other hand, has made that behavior easier by providing international currency, given its deficit of current accounts. Exemplary has been China's behavior, who has accumulated in 2008 about 2.000 billion dollars in reserves, reinvesting a great part of them in US Treasury bonds. The savings of the emerging countries are therefore financing the expenditures of the US citizens and Treasury. Other surveys have confirmed this trend. Financial integration has considerably increased in the last years, in particular among industrialized countries; the biggest imbalances are found between the USA and the emerging countries (and Japan, who has a sizable trade surplus); the euro area is substantially in balance. The United States takes a double advantage from the use of the dollar as international currency: the creditor countries find it convenient to reinvest their reserves in US bonds, and the US citizens and enterprises can draw money at low interest rates, and invest abroad with a considerably bigger return (Lane et al.2006). The volumes we are talking about are huge. The amount of monetary reserves, that in the industrialized countries does not exceed 4% of GDP, in the emerging countries is as high as 20% of GDP (in some cases it exceeds 50%). It is an abnormal level, which can be explained by the fear of a sudden financial and monetary crisis, that also affects the domestic banking sectors (Obstfeld et al. 2007).

The flow of savings from the poor countries to the rich could be considered, with reason, as a sign of global imbalance. In other phases of the world economic history – as during the gold standard in the 19th century or the first years of the gold-exchange standard after WWII – have been the rich countries in the center to finance the periphery, thus favoring a converging process. However, there are economists (Dooley et al. 2003 and 2004) who theorize a revival of the Bretton Woods system of fixed exchange rates, due to the presence of a mutual interest of both the central country and the peripheral countries to sustain their growth through an exchange of goods and investments. The peripheral countries point to an export-led growth strategy, which can be successful to the extent that the rich country in the center (the USA) is willing to keep its markets open; the central country imports low-cost goods from the periphery without arousing big social protests, because the low prices of imports reduce inflationary pressure, and because the multi-national companies in the center can reinvest capitals in the periphery, which in turn contribute to improve labour productivity of the guest country. The financial flows from the periphery, with high savings – collected by local authorities at low remuneration due to their control on capital movements –, are the reward for the US trading openness; in fact, the US is progressively replacing purchases from Europe with less-costly Asian products. This system is therefore bound to last, because it satisfies a mutual interest.

The idea of a new Bretton Woods, suggested by a tacit pact between central and peripheral countries, describes some important aspects of the present situation, but is not convincing. In the Bretton Woods years, there was one world currency only, the dollar, which could be used as reserve currency (in addition to gold). Now there is an alternative, the euro. One can then have doubts about how tenable the "new" Bretton Woods would be in case a process of replacing the dollar with the euro as reserve currency is set in motion (Kenen, 2005; Chinn, Frankel, 2008). It is necessary, therefore, to discuss further the basic problem of every international monetary system: who decides – and according to which criteria he distributes – the volume of world liquidity? To answer this question, it is appropriate to recall the criticism that Jacques Rueff and Robert Triffin addressed to the gold-exchange standard. After the first World War, Rueff recalls, despite the enormous increase of the monetary mass caused by war inflation, the governments wanted to go back to the gold system without devaluing enough their national currencies (in particular the sterling). As a remedy for the scarcity of gold, it was accepted that the national currencies could be used as reserve currencies beside gold (in that consists the gold-exchange standard). The consequence was that "the countries with a key currency, the USA and the UK, were given the peculiar privilege of being able to buy abroad without having to reduce their domestic demand: so, their balance of payments could stay indefinitely in deficit". On the other hand, in the group of countries with a convertible currency there was "a permanent inflation, generating economic expansion, but also rising prices". And as to the

Bretton Woods system in particular, Rueff (1963: 11-13) observes: "After 1945, we have reestablished the mechanism that has indisputably produced the disaster of the years 1929-1933". Basing himself on similar arguments, Robert Triffin forecasted, a decade in advance, the collapse of the Bretton Woods system of fixed exchange rates, because the US will be forced, in order not to let liquidity become short in the system of international exchanges, to issue increasing amounts of dollars in the presence of a stable, or decreasing, amount of gold reserves. Consequently, sooner or later the US pledge to keep stable the exchange rate at 35 dollars per gold ounce will become no longer credible. However, the end of the system of fixed exchange rates did not eliminate the fundamental flaw of a system of payments based on a national currency. Given the importance of the US economy and its political role, the dollar continued to be used as the key currency of international transactions. So, the United States has continued to enjoy its "peculiar privilege" of not having to worry about its external deficit. In one of his latest essays, Robert Triffin denounced the "international monetary scandal" of a system that was allowing the world's richest country to get loans from the poorest countries. In fact, the use of the dollar as reserve currency was encouraging its users to reinvest in the United States if only they could get a remuneration. But in this way "a self-feeding spiral of inflationary reserve increases" is created (Triffin, 1992: 14).

The above considerations on the inflationary character of the gold-exchange standard apply also with regard to the present revival of the Bretton Woods system, with the variant that inflation manifested itself more in the form of an excess of liquidity than of a rise in prices, because the imports into the industrialized countries of goods coming from low-labor-cost countries have kept in check the cost of living and the rise in wages. Moreover, due to the fact that the US enjoyed the advantage of sizable flows of foreign capitals in public and private securities, it could keep interest rates low. In that context, the exuberant US financial market has created those toxic assets that originated the present crisis. It has to be observed, in conclusion, that the high level of reserves in the developing countries represents an inefficient way of investing world resources, because, as Stiglitz (2006: ch. 9) notes, those countries could rather use those dollars, coming from an export surplus, for domestic investments in public goods: that represents a further cost of an international monetary system based on a national currency.

We can now conclude by listing the fundamental requisites that should characterize a World Eco-monetary Union, whose initial core of countries could be formed by the United States, the European Union and other industrialized countries, and possibly by a number of developing countries too. Considering the experience of the European monetary union, those requisites should be at least three: a) a return to fixed exchange rates among the various monetary areas; b) a supranational governance of international liquidity; c) a common budget. Let us now briefly comment on these three requisites.

A fixed exchange rates system is a need particularly felt by both the developing countries, which are willing to pay a high price in terms of a high volume of their reserves, if only they could attract foreign direct investments and assure new markets to their products, and the industrialized countries, willing to stabilize their commercial and financial relations. However, a return to fixed exchange rates is considered impossible due to the so-called "inconsistent triad": there cannot exist at the same time independent national monetary policies, stable exchange rates and free movements of capital. To overcome this objection, it has to be observed that in a unified (with fixed exchange rates) monetary area, capital flows can spontaneously take a "stabilizing" direction more favorable to the development of the areas with low labor-costs. Among the countries that created the monetary union in Europe, there are of course imbalances between their respective balances of payments, although overall the monetary union is practically in balance in its relations with the rest of the world. But those internal imbalances, even significant, do not generate such tensions as to produce monetary crises and capital flights, as happens in the international arena when a "foreign" currency is used as reserve currency. The European countries have freed themselves from the constraint of the balance of payments, which does not appear any longer among their economic policy objectives, even if other constraints, like those fixed by the Stability Pact, must be observed. A very interesting study (Aherne et al, 2008) on the imbalances between the countries of the European monetary union highlighted that as a tendency the countries with a high per-capita GDP also have trade surpluses but, on the other hand, the flow of capitals heads for the countries with a per-capita GDP lower than the average. A converging process is thus created which appears to be very problematic in an international system based on a national currency which is also reserve currency. Moreover, belonging in a monetary union – in particular when it is of world dimensions – shelters the member countries from external turbulence. The recent financial crisis showed that the European countries still outside the euro area, like Hungary, were subject to serious pressures due to capital flight (flight to quality), and they were able to counter them only with the aid from the ECB and the IMF (Darvas et al. 2008). The symptoms of this crisis are not very different from those that hit the Asian countries in 1997.

The second problem, that of the responsibility of last resort for the creation of international liquidity, is crucial. The European experience showed that until national governments were able to decide their domestic inflation rate according to their needs of economic policy, also their exchange rates did not remain stable. On the other hand, fixed exchange rates are one of the conditions of economic development. The possibility for economic agents to fix contract prices in a stable currency represents an indisputable advantage of domestic trade as opposed to international trade. International transactions are penalized in comparison with the domestic ones because the risk deriving from a change of value of the currency in which the contract is signed is not eliminable. If the conditions are to be created for letting international trade and finance develop as much as they do at home, it is necessary to solve at the root the problem of the responsibility of last resort deciding on the volume of international liquidity. Since the end of WWII, has been the USA to perform that function. But the USA has shown that it carries out its responsibility with an eye to national interests more than to the stability of the international economy. The creation of the euro does not change much this problem. In the first half of the 20th century, the dollar replaced the sterling as key currency. But in the century of globalization it would be irresponsible to point at a competition between the dollar and the euro for world supremacy. In the long term, the establishment of a multipolar world with conflicting big political actors, like China, India, Russia, etc., in addition to the USA and the EU, would make a scenario of fragmentation and disruption of the economic order probable. For globalization to develop, it is necessary to build a symmetrical international monetary system. The USA, sooner or later, shall become aware of the new reality. A stable currency is a public good that must be guaranteed to all of the countries that are using it. It is necessary then to entrust to a supranational authority – a central bank – the task of providing liquidity to the world economy, according to criteria and objectives agreed between the member countries of the Eco-monetary union: for example, the average inflation rate should not exceed a certain value. The central bank could provide liquidity to national central banks using a basket of currencies, like the Special Drawing Rights (SDR), which will be also used for bank transactions, but not necessarily shall it become a circulating paper-money. The dollar could then be gradually replaced as international reserve currency[VI]. National currencies can remain, as happened during the transition to the European currency, when fixed parities were established among currencies, the ECB was created with the power to determine the quantity of the new currency, but the replacement of national banknotes with the euro was postponed to a later date. The question, that is not to be dealt with immediately, is whether a Stability Pact, imposing constraints on the national budgets, will be necessary also for the countries of the World Eco-monetary Union. Such a decision would certainly meet at this moment strong political resistances. Therefore, the question that must be further studied is whether it is possible that the World Central Bank can guarantee monetary stability (that is to say, an average inflation level) and the stability of exchanges without constraints on public expenditure. In Europe it was decided that the two sources of inflation – the power to issue paper money and public debt – must both be regulated at the European level. However, it could be decided to let the international financial markets be the watchdog against excessive national deficits, because financial integration has by now reached such a level that quite unlikely could a government find money at the world interest rate, with no additional spread for risk, if it does not give serious warrants on its financial situation. Indeed, States have margins for maneuver not dissimilar from those of enterprises, and like enterprises they can default if they do not follow prudential financial rules.

However, without a Stability Pact for the World Eco-monetary Union, it is necessary that the cohesion among the member countries be assured by efficient common policies. The last problem concerns then the necessity to institute a public budget, financed with autonomous resources, that can allow the member countries to put in place the policies that the market cannot realize. The budget is the instrument for the world-level regulation of sustainable development. If there were no possibility to realize common world policies, the individual governments would be forced to put in place substitutive policies, less efficient and non-coherent. Basing itself on its own resources, the World Union could instead realize policies fostering the development of poor countries and their integration into the world economy. The Union could also face the problem of an ecological reform of the economy. Finally, it could make access easier for those countries that cannot immediately join the Union, but are willing to do so later. It is not possible here to quantify the budgetary needs of the World Eco-monetary Union for such aims, but suffice it to recall that in the European Union a budget amounting to about 1% of GDP has been sufficient so far to finance the economic and social cohesion policies and the environmental policies. The European Union, if it wants to realize more ambitious policies, cannot content itself any longer with such a small budget. However, for the World Union, a budget of 1% of the world GDP would represent a significant step forward with regard to the present situation, where the UN has no own resources to draw from for the policies it is proposing, which, exactly for that reason, remain almost completely not accomplished.

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I About the European integration as evolution from an original federal core see Montani, (2008).

II For an incisive criticism of the "efficient markets" paradigm, see De Grauwe, 2008.

III One could also propose a direct role of the ECB in the supervising function, although the ideas on the matter are mostly in favor of a separation between the peculiar functions of central banks and those of supervision. See Masciandaro, Quintyn, Taylor, 2008.

IV It does not seem appropriate to institute a budgetary chapter reserved to specific interventions to support the banking system. A chapter for interventions to support disasters, epidemics and catastrophes seems more appropriate, in order to avoid that the creation of a specific rescuing net becomes the unintentional cause of the instability of the banking system, as argued by Calomiris, 2007.

V See, on this matter, Montani, (2008: 186-191).

VI A gradual replacement of the dollar with the SDRs issued by the IMF is suggested also by Kenen (2007).

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