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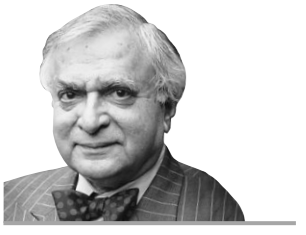
Europe in decline

Current European politics is unlikely to provide the necessary cure for the euro zone's economic woes



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Earlier this month, I was in Venice to participate in the Aspen Institute Italia's transatlantic dialogue on the theme, "Pivot to Europe: options for a new Atlantic century". There were wide-ranging discussions on the ways out of the global economic crisis, the Atlantic link on the issues of global security and crises, and on the prospects for the ongoing negotiations for a transatlantic trade and investment partnership (TTIP).

It rained all the five days my wife and I were there. Piazza San Marco, where the participants gathered in the grand Sala dello Scrutinio of the Doge's Palace, was flooded. This was a reminder of the fragility of this ancient and beautiful imperial city, which seemed to be slowly sinking into its bay. This was reflected in the gloom about Europe's prospects emanating from the meeting, despite the attempts by various European functionaries to talk up its prospects.

On the economics themes, a number of points emerged. First, as Allan Meltzer, a historian of the US Federal Reserve, pointed out, the various rounds of quantitative easing (QE) have merely increased bank reserves on which the Fed pays 0.25 per cent interest to keep them idle. So most of the reserves created by QE have not led to an increase in the money supply. Bank reserves had risen 31 per cent in the 12 months to July, but money supply increased by only 6.8 per cent. No wonder the US recovery has been so slow and inflation so low. The banks, by contrast, are sitting pretty; they hold $2 trillion in excess reserves and get $5 billion a year without any risk.

In my contribution, I pointed out that the unsustainable entitlements to politically determined income streams, which had led to the crisis, had not been seriously tackled. For these include not only the explicit entitlements of the welfare state, but also the even larger implicit ones created for the Masters of the Universe of the financial system, which, according to the estimates of Bank of England's Andrew Haldane, often exceed the value added by the financial sector to the gross domestic product [see his "Control Rights (And Wrongs)", *Economic Affairs,* June 2012]. Only a Glass-Steagall separation of commercial and investment banking will end them — as all the rules being devised, from Dodd-Frank to Basel, will inevitably be gamed by universal banks. It may be necessary to remove limited liability from investment banks, and convert them into unlimited liability partnerships, with "skin" in the risk-taking games they must play.

The other major economic issue that was discussed was the implications for Europe of the shale oil and gas revolution in the US. This poses both an economic risk for Europe, with its energy prices a quarter to a third higher than those in the US, and a security risk, with the US' growing energy independence from suppliers in West Asia. The former implies that much of heavy industry is likely to shift from the continent to the US — a prospect made more likely by Europe's green climate change agenda and the high costs and unreliability of the various renewable sources of energy being promoted. Now that Germany has turned its back on nuclear power, and France has imposed a ban on fracking for shale gas and oil, Europe's industrial future looks bleak.

The security prospects are worse. With increasing domestic availability, the US' strategic interest in West Asia to ensure security of supply of fossil fuels will decline. The Europeans have been free riders in the post-war global order of the US imperium. This will now have to change. But since the only two serious European military powers – the United Kingdom and France – are unable to maintain their recent levels of defence spending, and since the Germans have the means but not the will to fill the breach, the impending US withdrawal will require Europe to bear the burden of continuing West Asian turmoil by itself — including terrorist threats, and refugees fleeing from the conflicts in North Africa. This will prove a challenge, particularly given the growth of anti-immigrant far-right political parties during the current slump in the euro zone. The tragedy of the sinking of the refugee boat near the island of Lampedusa on the first day of the conference highlighted this danger.

Given all these challenges, leaving aside the continuing problems of the euro – which the German economists at the conference emphasised will not be solved by any implicit or explicit German bailout – the major hope of the European participants was that TTIP would be their salvation. Most agreed with Harvard Kennedy School professor Robert Lawrence's economic assessment that, as their tariff levels are low, the main gains would come from harmonising regulatory policies ranging from food safety to automobile parts.

But it soon became clear that the major purpose of these negotiations for the Europeans was the construction of a transatlantic fortress against the rising emerging economies (particularly China and India). The Americans hope that, by excluding these "refusniks" of the multilateral Doha agreement, TTIP will be a lever in changing their mind. More sinister to my ears was the suggestion that agreements on labour and environmental standards in TTIP could become the gold standard for future trade agreements.

A lot of what I heard was whistling in the dark — hoping that the clouds threatening Europe would lift. But this is to misdiagnose their problem. For, while Europe still contains enormous entrepreneurial talent and a highly skilled labour force, its dirigiste economic policies have failed its citizens. This was evident as one walked around the narrow Venetian streets, with the shops stocking Italian designer clothes, crafts and a myriad other products. The thrifty Italians have little private debt. They have been laid low by the entitlement economy of the Mezzogiorno and by the euro. As I suggested at the meeting, instead of the various dirigiste remedies that were being proposed to cure Europe's woes, the simplest was for Germany to exit the euro for a new Bismark, leaving the European Central Bank to manage a highly devalued euro for the Club Med and France. But current European politics is unlikely to provide the necessary cure to prevent both Venice and Europe from sinking.