Lessons from Europe

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The perception is that European economic integration has rendered member countries stronger and more resilient. The current global economic crisis provides a rare opportunity to test that hypothesis.

Of course, no one can be absolutely sure how the European countries would have responded to or been impacted by the crisis in the absence of the Eurozone. One could only speculate on this, but it is still possible to make some fairly reliable inferences by looking at countries that had opted not to join the Eurozone.

Apparently the Eurozone countries have faired somewhat better than other European countries, lending some credence to the view that regional economic integration does help.

There is a general consensus that the United States is the epicentre of the current global economic crisis. If this is indeed so, it is not difficult to conclude that the crisis had spread from the United States to Europe through financial and trade channels, as it has spread to the rest of the world.

But, it is important to underline that the European Union (EU) is relatively a closed economy, with extra-regional trade accounting for a small proposition of gross domestic product (GDP), which suggests that the crisis was transmitted from the US to Europe primarily through financial, not trade, channels.

This line of reasoning suggests that impact should have been less severe in Europe than it has been for East Asia, given the latter's huge exposure to the US economy both financially and commercially. But it has turned out to be otherwise, with the Europe feeling the heat more than East Asia.

One must not, however, jump to the conclusion that regional economic and monetary integration has not protected Europe from the global crisis.

It is not difficult to explain why the Eurozone has been hit harder than East Asia. It is incorrect to assume that the crisis in the Eurozone is purely external, unlike East Asia's. It is partly home grown: there have been fault lines within Europe that led to a premature implosion triggered by the crisis emanating from the US.

The Eurozone's endogenous bubbles might have burst on their own accord, but available evidence suggests that they might have lasted a little longer had it not been for the bursting of the bubbles in the US.

There are important differences between the US and the Eurozone economies, yet the differences in terms of the severity of the crisis in these two areas appear to be surprisingly small.

Besides, the impact on the financial market differs markedly from that on the real sector of the Eurozone economy, which also begs explanations. Evidently, the Eurozone's financial market has suffered less than that of the US. Presumably, the financial institutions in the Eurozone are better regulated and better governed than their counterparts in the US.

What is even more surprising is that the real sector of the Eurozone has contracted more sharply than that of the US, despite the fact that the Eurozone is a relatively closed economy and that its financial sector has fared a little better than that of the US.

Arguably, the sharper real sector downturn in the Eurozone, relative to the US, can be attributed largely to its inflation concerns, which had led to the maintenance of tight money policies, and its commitment to fiscal discipline, which led to the imposition of a three per cent ceiling on budget deficits as percentage of GDP.

As a matter of fact, the European Central Bank (ECB) was slow to reduce interest rates, given the fear of fuelling inflation, and has trailed with a one-year lag behind the US Federal Reserve in the downward adjustments of interest rates. The delayed monetary response by the ECB could have contributed to the sharper economic downturn in the Eurozone.

It also appears that the self-imposed fiscal restraint of the Eurozone may have made its real sector more vulnerable to the crisis. While the Eurozone countries have no autonomy in monetary policy, they still have some leeway on the fiscal front. Some of them, especially those bordering the Mediterranean, have exceeded the 3 per cent ceiling, taking advantage of the exemption clause allowed in exceptional circumstances.

It is too early to see if these economies perform better than those that have adhered to the fiscal ceiling.

Be that as it may, the euro currency has been quite stable in the foreign exchange market in contrast with other European currencies, which have exhibited greater volatility and experienced sharper depreciation. This apparently speaks well of regional monetary integration.

There may be some lessons here for East Asia, which has thus far treated the idea of a common currency as outlandish. Perhaps, the time has come for East Asia to rethink this matter.

All this notwithstanding, one still wonders if those European countries which did not join the Eurozone were actually better off, in that they have an additional macroeconomic instrument in the form of exchange rate adjustments. It will be interesting to see if the EU members outside of the Eurozone can recover faster than the Eurozone members.

No one can be sure how long it will take for the Eurozone to bounce back into the growth trajectory. However, it is not difficult to argue that the Eurozone will be the last to recover after East Asia and the US, given the rigidities of close-knit economic and monetary regional integration.

If such rigidities stand in the way of recovery, the chances are that a prolonged recession, or an "L-shaped" recovery, might undermine European regional integration itself.

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