For richer, for poorer? The European Union that never was

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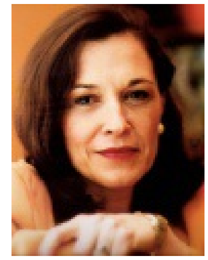


Lyric Hale *discusses the European Union's economic troubles and how they compare with the early crises of the US's federal system. In both cases, she argues, political unity is invaluable to ensure the success of these overarching economic projects. But as recent developments in Europe unfold, it is clear that political consensus is an increasingly unlikely prospect.*

Ironically it was risk avoidance, and the willingness of investors to believe that they could insulate themselves from risk, that created the Great Financial Crisis. So is it any wonder that continuing to play it safe might only make it worse? The system has seized up and will continue to seize because of a fundamental lack of understanding by governments of what creates a growth environment for the economy. Unable to instill confidence, politicians seem blind and removed from the realities of the lives of their citizens. As Robert Zoellick, outgoing president of the World Bank warned last week, it is "far from clear leaders are ready for impending catastrophe". A truly disturbing statement by someone who actually knows them and what they are thinking.

Robert Zoellick

The warning signals are flashing again. Last week's dismal US employment figures underline the trend to avoid investing in human capital, and tellingly, teachers suffered some of the greatest job losses last month. According to Diane Swonk, chief economist at Mesirow Financial, "The bulk of the losses in public sector employment occurred in cuts to both state and local teaching positions". The markets are reacting to the prospect of fewer workers. There is no doubt that employment is necessary to recovery, in order to create customers and retail demand, but large corporations and small businesses find themselves reluctant to hire.

This is entirely rational in an environment of uncertainty. Not knowing what the tax structure might be in 2013, lack of faith in global markets, and the ability to displace labor with technology all play a part. Governments, companies, banks, and households around the world all feel the imperative to de-leverage their balance sheets rather than take on additional overhead. One bright spot, falsely seen as a malignancy—credit card debt has begun to increase. Thank heavens for the American consumer! Give every citizen a $1000 debit card, to be used on purchases over ninety days, and you would witness the greatest example of a multiplier effect ever seen and a potential increase in the GDP of 2.2%.

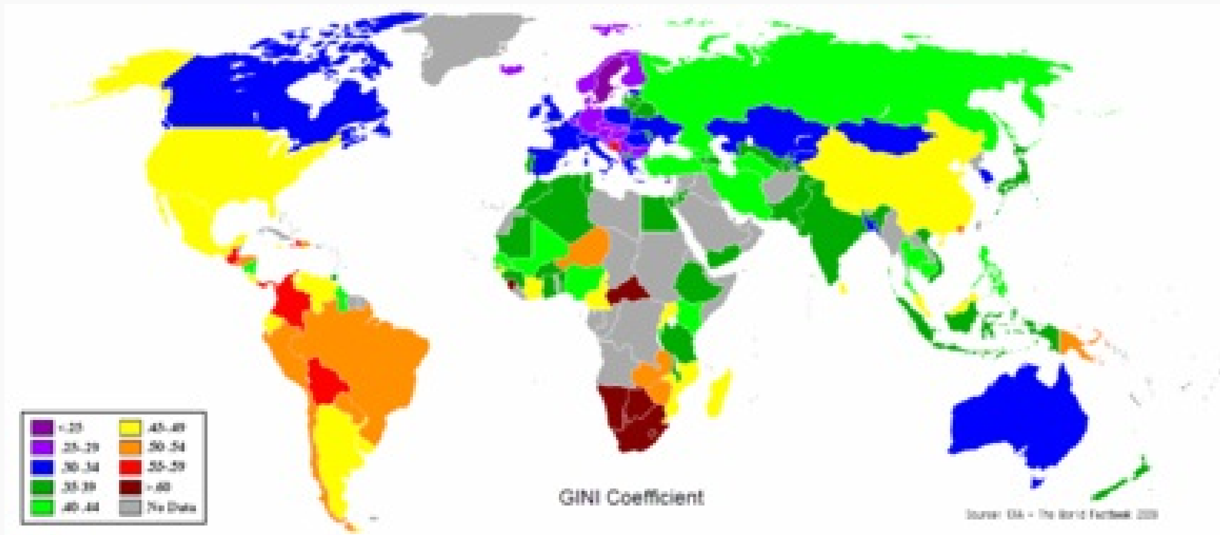
Estimated Impact of Debit Card Stimulus for Civilian Noninstitutional Population (16+)		
Civilian Non-institutional Population		242,966,000
Multiplier		1.45
Debit Card	$	1,000
Total Increase	$	352,300,700,000
Est. Year-End GDP	$	15,743,762,500,000
GDP Increase		2.2%

Spending is necessary to create growth, but spending is bad, say the bureaucrats. Confusing until you pull this apart. The real issue is misallocation of capital, by governments, financial institutions, and individuals. Over the past few months, austerity has been the battle cry of politicians in full retreat from reality. Growth is the only way out, but either they haven't caught on or they lack the vision required to lead the charge forward. Instead they think regulation-aha! and put pressure on the banks to raise their capital requirements—in other words, hoard cash. Ambrose Evans-Pritchard quotes What's Next? contributing author Timothy Congdon in the *Telegraph*:

> *“What they are doing is frightening. If banks shrink their balance sheets, it destroys money. It causes a credit crunch and intensifies the recession. This is why we are facing a global slowdown.”*

Source: Mark Zoff, David Hale Global Economics

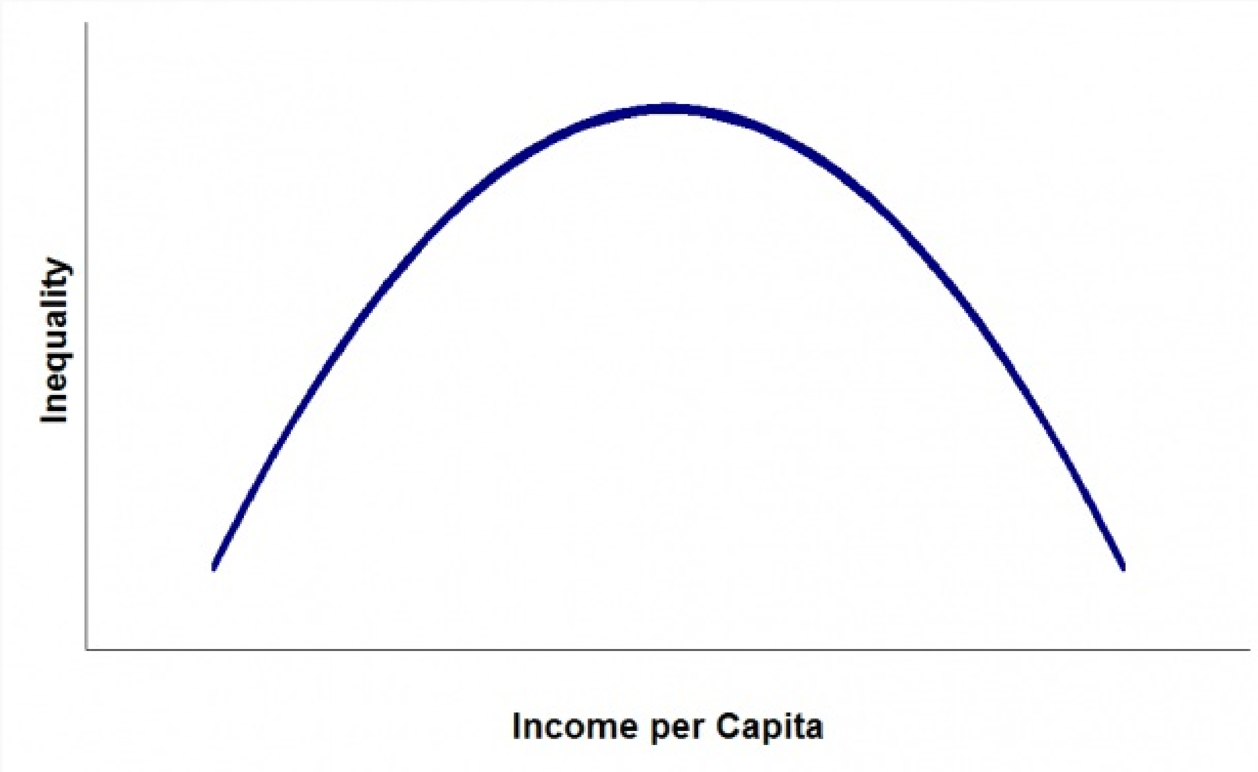
The world is a very rich place with a lot of money sitting on the sidelines, especially in corporate treasuries. Like it or not, regardless of one’s political perspective, growth will mean income redistribution between individuals, and states. In the past decade, both income and assets have followed a top-heavy migration to the very rich. The gini coefficient, a measure of the distribution of wealth, is showing income inequality in the US as record levels. The middle class in the developed world has found itself squarely in the hairs of the crossfire, with less money to spend.



Gini coefficient of national income distribution around the world (using 2009 data) (wikipedia)

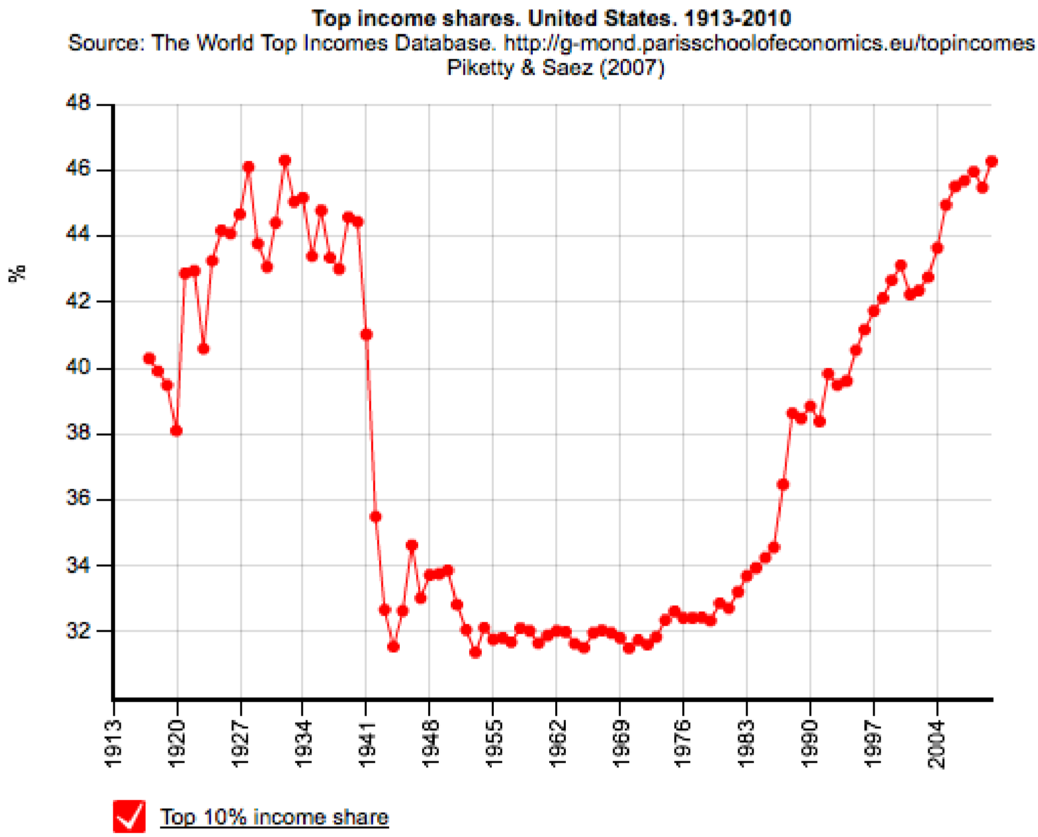
One of

the great debates in



Kuznet’s Curve (wikipedia)

economics is the relationship between income inequality and growth. Kuznet’s Curve describes the situation in which things get worse in terms of income inequality prior to industrialization, after which things get better and everyone gets their fair share. However, this promised U-curve doesn’t seem to be working now, and is causing a rip in the fabric of the social contract to allow temporary unequal distribution in order to attain overall prosperity in the long run. The volume of railing against the lucky 1% and attendant civil unrest continues to grow. As Jose Gabriel Palma at Cambridge University writes, “the statistical evidence for the ‘upwards’ side of the ‘inverted U’ between inequality and income per capita seems to have vanished.”



This has profound political implications. *Guardian* economic commentator Stewart Lansley points out the dangers of income inequality in Britain and the US.

> *The economic orthodoxy of the past 30 years holds that a stiff dose of inequality brings more efficient and faster-growing economies. It was a theory that captured the New Labour leadership – as long as tackling poverty was made a priority, then the rich should be allowed to flourish.*
>
> *So have the architects of market capitalism been proved right? The evidence says no. The wealth gap has soared, but without wider economic progress. Since 1980, UK growth and productivity rates have been a third lower and unemployment five times higher than in the postwar era of "regulated capitalism". The three post-1980 recessions have been deeper and longer than those of the 1950s and 1960s, culminating in the crisis of the last four years.*
>
> *The main outcome of the post-1980 experiment has been an economy that is much more polarised and much more prone to crisis. History shows a clear link between inequality and instability. The two most damaging crises of the last century – the Great Depression of the 1930s and the Great Crash of 2008 – were both preceded by sharp rises in inequality.*

Today we have a prime example of a country that has progressed from almost perfect equality to huge income spreads, particularly between its urban and rural populations–China. However, the country's growth rate has begun to slow just as the Chinese gini coefficient hit US levels, creating a wealth gap. The ensuing possibilities for instability there are not lost on China's leaders who have continued to suppress dissent. In any discussion with Chinese policymakers, the phrase most likely to reward one with a spirited response is "income inequality".

This leads to the problem of Europe, or rather the European Union. The EU was also an effort to mitigate political risk, particularly, the risk of war between its member states and maximize economic opportunities. The risk of military conflict does in fact seem remote, but another kind of conflict has taken its place. Political sacrifices will have to be made to solve the current crisis, but this seems unlikely. As Ambrose Evans-Pritchard writes in the *Telegraph*:

> *Germany can break the logjam at any time by agreeing to fiscal union, debt-pooling and full mobilization of the ECB, with all that this implies for its democracy. The answer from Chancellor Angela Merkel over the weekend was 'under no circumstances'. In that case, prepare for the consequences.*

Germany and France might have a socialist bias, but for its own citizens. Germany continues to view Greece's crisis as a moral issue, which it is not, rather than as a problem of redistribution of income, which really means taxation. EU taxes are a mere 1% of European GDP, but federal (not state) taxes in the US make up about 20% of GDP. When we pay federal income taxes, citizens of my home state of Illinois know full well that not all of the proceeds will be used within our borders. We know in fact that these funds will be spent as allocated by Congress in poorer states such as Alabama and Mississippi. We accept this as the price of our federal system, our national union. The underlying promise is that we all benefit as a country. Our elected representatives have to work out how much is spent for each particular part of the budget. This is a contentious rather than harmonious process, and we might face a failure of these negotiations in the near future. But the policy debates are more along the lines of defense spending vs. entitlement programs, rather than state or geographic borders. They don't threaten the union itself.

In fact, they once did, but Alexander Hamilton played a role which was recently described by Thomas Sargent in his Nobel Prize lecture in 2011, entitled "United States Then, Europe Now". He says that the crisis Europe is facing today is similar to the crisis faced by the US at its inception, but before the Constitution during the 1780's:

> *In terms of fiscal arrangements, the EU today has features reminiscent of the U.S. under the Articles of Confederation. The power to tax lies with the member states. Unanimous consent by member states is required for many important EU-wide fiscal actions. Reformers in Europe today seek to redesign these aspects of European institutions, but so far the temporal order in which they have sought to rearrange institutions has evidently differed from early U.S. experience in key respects. The U.S. nationalized fiscal policy first, and for the U.S. framers, monetary policy did not mean managing a common fiat currency, or maybe even having a common currency at all. The EU has first sought to centralize arrangements for managing a common fiat currency and until now has not wanted a fiscal union. And to begin its fiscal union, the U.S. carried out a comprehensive bailout of the government debts of the individual states. So far, at least, the EU does not have a fiscal union, and few statesmen now openly call for a comprehensive bailout by the EU of the debts owed by governments of the member states.*

In Europe however, this consensus for burden-sharing does not exist, and it is plain to see that the privileged are worried about sharing their wealth with their poorer neighbors. After all, the European Union is not a federation. It is a collection of countries with different cultures, languages, histories, and economies that use the same token as currency. The European Union budget as a proportion of the Eurozone's GDP is clearly not enough to create the glue that would bind them all together in common cause. If the euro, or the European Union itself collapses, it will be a political rather than an economic failure, which is fair because it began as a political endeavor. A break-up would be more of an annulment than a divorce, because the conditions of marriage were not met from the outset. In particular, "for richer, for poorer, in sickness and in health". That promise was never made.

This article originally appeared at Yale Books.

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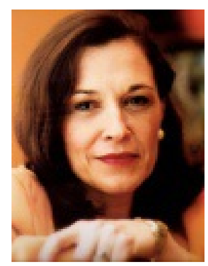
About the author

Lyric Hughes Hale is a writer and contributor to a range of publications, including the *Financial Times, Los Angeles Times, USA Today, Current History* and *Institutional Investor*.

What's Next?

What's Next? Unconventional Wisdom on the Future of the World Economy by David Hale and Lyric Hale is available now from Yale University Press.



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