The EU and the Credit Crisis

John Grahl

Some political leaders in the EU – German Finance Minister Peer Steinbrück, British Prime Minister Gordon Brown and European Commission President José Manuel Barroso are significant examples – have suggested that the current crisis of the financial system is an essentially external phenomenon, arising in the United States or in the global economy in general. This denial of a specifically European responsibility goes together with a failure to address important weaknesses in EU structures and policies.

Several political and economic developments in the EU increased the exposure of European economies to the crisis. Firstly, banking supervision in the EU seems to have been even more lax than in the US: Daniel Gros and Stefano Micossi report that EU banks are significantly more leveraged than their US counterparts; this both increases the danger of bank failures and makes the necessary stabilisation of bank balance sheets a longer and more damaging process.[1]

Secondly, the drive for financial integration which has been a central feature of EU policy for ten years has been pursued by the European Commission with a reckless disregard of the dangers to stability involved.[2] For example, the Directorate-General Internal Market and Services was preparing a plan for an integrated mortgage market closely modelled on the deregulated mortgage market in the US. Only when the US mortgage market collapsed did the Commission rapidly withdraw their proposal. In fact, the financial integration strategy was inspired by a completely uncritical view of the US financial system which was seen as the only possible model for European development.

The same uncritical view of the US model can be found behind the Lisbon agenda as a whole. It was also a very one-sided view: there was never any thought of reproducing the public agencies or government interventions which complement market processes in the US – all that mattered was to establish a continent-wide market and to drive down transactions costs. This is the same mind-set as that behind the extremist Bolkestein directive for service-sector integration: only market-led integration is important; if established methods of social control at national level are undermined, this, in the view of the Commission, was all to the good.

Thirdly, the established macro-economic regime in the EU does not contribute to financial stability and is, indeed, in some respects actually dysfunctional. The mandate of the European Central Bank (ECB) is focussed on yesterday's battle against inflation; it leaves most issues of financial stability to member states. The ECB is permitted (but not required) to advise on stability issues and to participate in the prudential supervision of banks and other financial corporations. In practice it leaves such supervision to member state authorities. The biggest gap is the lack of any definite responsibility to contribute to the efficient management of the global monetary and financial systems. Thus, although the ECB responded very correctly to the need for liquidity in the crisis it was constitutionally inhibited from taking a full role in its resolution.

The budgetary side of the EU macroeconomic regime is even weaker. Collectively, the Eurozone has immense strength and an unrivalled ability to mobilise financial resources to meet the crisis. But the central EU budget is too small to be of any macroeconomic significance and there are no mechanisms of coordination or redistribution to give overall coherence to member state budgetary policies – only mechanical and dysfunctional limits on deficits and national debts under the Stability and Growth Pact. Now, by the autumn of 2008 it was widely recognised that budgetary measures would be necessary firstly to recapitalise many of the banks, and secondly to sustain aggregate demand in the face of a serious recession.

In this situation the rules of the Stability and Growth Pact are worse than useless and several member states are bound to violate them. The key weakness of the macroeconomic regime in the present crisis is its lack of solidarity. The theory of monetary unions demonstrated forty years ago that they require some means of responding to divergent trends in competitiveness and levels of production – for instance with fiscal transfers or with coordinated incomes policies. The European Monetary Union has no such instruments – for that reason the French economists Aglietta and Berrebi refer to it as a »false monetary union.«[3]

In aggregate the Eurozone is enormously strong – with an immense productive system, a stable currency and a much stronger balance of payments than the US. But the lack of budgetary coordination and the absence of internal transfers undermine this potential strength. The danger of a crisis within the EMU is growing because of the growing polarisation between surplus countries (Germany, the Netherlands or Austria) and those with widening deficits (especially Spain, Portugal and Greece). If the weaker countries are forced to correct their positions through mass unemployment and wage deflation the whole EMU can be called into question.

Similarly, the Eurozone as a whole is very creditworthy – it ought to be running at least a temporary payments deficit both to stimulate employment in its own economy and to ease the general problems arising from a reduced payments deficit in the US. There is no conceivable problem for the eurozone as a whole in financing a strongly expansionary budgetary stance. But if there are no moves to reduce internal tensions there could be serious problems for some of the weaker member states and their financial problems could shake confidence in Eurozone credit in general.

A further threat to the EU financial system is the widespread financial disarray in many Central and Eastern European countries, with both Hungary and the Ukraine already having had to apply to the IMF for emergency funds (this should surely not have been necessary for an EU member state such as Hungary). The big European banks have big exposures in many of these countries.

Although interventions at member state level have so far sufficed to avoid major bank collapses, it is quite possible that rescues will be necessary in the future which exceed the capacity of individual member state governments. Willem Buiter[4] writes:

> *The problem of systemically important banks or other financial institutions whose need for external resources beyond what can be financed privately exceeds the fiscal capacity of its government, is not only confined to small countries with large banking sectors and their own currencies. Switzerland, Denmark, Sweden, Australia*

and New Zealand are vulnerable, but so are Belgium, Ireland, the Netherlands and Luxembourg, even though they are members of the euro area.

A system of mutual guarantees of member state borrowing and the constitution of an EU emergency fund would allow the EU to act as a whole and to mobilise its full economic and financial strength. These measures would also be important steps towards a more solidaristic and coordinated union.

The minimalist and conservative positions adopted by the European Commission fall far short of what is needed. According to Commission President José Manuel Barroso all that is really required is to continue with existing policies and institutional structures. The Commission's key document on the crisis is essentially an apology for existing policies, without the slightest acknowledgement that the continuous drive for market-based integration over the last two decades and the consistent disregard of public goods have helped to bring about the current situation.[5] It is asserted, for example, that »Europe's strength lies in its solidarity and our ability to act together,« and it is said that the actions taken so far by member states have been »coordinated.« This seems to be a very exaggerated claim: many governmental interventions to prevent bank failures have been carried out basically on a unilateral basis with minimum consultation of EU partners. For example, the unconditional Irish guarantee of all deposits in its banking system was seen by other states as an aggressive move which threatened a flight of deposits from their own banks to Irish ones. Some assistance from the EU, »together with the IMF,« is promised to Central and East European countries struck by the crisis, but no general move is to be made away from the regime of national budgetary policies without coordination or redistribution.

The cost of the fragmentation of European fiscal policies can be measured in the divergent borrowing constraints facing member state governments. In general, long-term interest rates on government debt have tended to fall because wealth-holders have been avoiding most private-sector placements. At the same time, however, the risk premia exacted from the weaker member states have widened. In October 2007, yields on ten year government bonds ranged from 4.28% in Germany to 4.60% in Cyprus, with the 4.92% rate in Malta as an outlier. One year later the rate in Germany had fallen to 3.88% but the spreads had widened significantly so that the highest yield, in Greece, was 4.93% with rates in Ireland, Italy, Cyprus, Malta, Portugal and Slovenia all above 4.5%.[6]

Several existing policies are reaffirmed in the Commission document. The Growth and Stability Pact is said to provide »the correct framework« for budgetary policies in the crisis and its excessive deficit procedure should be seen as »peer support.« EU Competition policy is said to make a »vital contribution« to the coordination of member state bank rescue plans. This is a questionable assertion: in fact member state governments undertook emergency recapitalisation of the banks in complete disregard of the EU rules on state support and they were quite right to do so. The public good of financial stabilisation outweighed the competition rules. The appropriate conclusion ought to be that other public goods should be taken into account in the implementation of competition policy. Instead of drawing such a conclusion the Commission seeks the earliest possible return to business as usual. It even demands »a level playing field« for competition between banks which have and those which have not received state support. This seems a chimerical objective. Intense competition among banks, pushing them to seek higher yields and to neglect increasing risks, was part of the problem.

Similarly, the Commission reiterates its by now routine demand for »structural reforms.« As usual these are not specified in any detail but the expression can usually be interpreted to mean privatisations, social security cutbacks and the relaxation of labour market regulations. None of these seem likely to contribute to the maintenance of output and employment in the deepening recession; nor is there compelling evidence that they would contribute to longer run economic development. No doubt, however, they would serve the interests of the corporations which play such a large part in the formulation of EU policies.

The Commission also repeats the call for »flexicurity.« This term has a number of meanings. One meaning is that there is a public interest in helping people make successful transitions – from education to employment, for example or from unemployment back into work. This is surely a very desirable approach to social security.

Another meaning raises serious problems: this is the view that, provided there is effective help to reintegrate unemployed people into the labour market, job security is not important and job protection is an unnecessary constraint on employers. This is the view that employment security can replace job security. The Commission document seems to endorse this interpretation; it speaks of »promoting flexicurity as way of protecting and equipping people rather than specific jobs.«

Now this approach is damaging because of what is known as »unemployment scarring« – the fact that often the unemployed are only reintegrated into employment at a lower wage than they previously received and with worse working conditions. Such scarring does not always occur but it is very frequent and it becomes far more likely when there are mass dismissals due to a downturn in the business cycle or the closure of a very large workplace. If job security ceases to be a policy objective in the present recession then the interests of many thousands of vulnerable workers will be sacrificed.

The Commission's response to the crisis thus exemplifies what will no doubt be a standard position among conservative political and corporate leaderships. All that these groups see as necessary is the speediest possible return to the *status quo ante* with reforms largely confined to strengthened regulatory procedures in the financial sector itself. A minimalist position of this kind ignores the fact that the credit crisis comes as the culmination of three decades of neoliberal policies which have dismantled key systems of public intervention and control, accepted the continuous widening of inequalities and transferred power over many aspects of economic activity from democratic decision-making to the rule of business enterprises and deregulated markets. Since the 1980s, EU leaderships have been a major force behind this drive, always promoting integration through the creation of markets and doing less and less to correct their functioning.[7] The Lisbon Agenda, which established policy priorities for the EU in the first decade of the new century, is a clear example of this approach: »flexible« labour markets and financial market integration – essentially following the US model – were seen as the only way forward.

The justification of the neoliberal position was always that it pointed to the only path to prosperity. Actual outcomes, and the credit crisis in particular, belie this claim.

Many European people already feel that European construction is being pursued with a ruthless neglect of social priorities and this has tended to undermine its legitimacy even in countries, such as France, the Netherlands and Ireland, where most citizens were in the past convinced supporters of the project. Only a genuine change of direction offers an escape from the resulting impasse.

Notes

1 *Financial Times*, 29th September 2008.
2 See the testimony to this effect of Alexandre Lamfalussy, »Creating an integrated European market for financial services«, in Philip Booth and David Currie, eds., *The Regulation of Financial Markets*, Institute for Economic Affairs, London, 2003
3 Michel Aglietta and Laurent Berrebi, *Désordres dans le capitalisme mondial*, Odile Jacob, Paris, 2007, p 209.
4 »Some suggestions for the G-20 on November 15th« in Barry Eichengreen and Richard Baldwin, editors, *What G-20 leaders must do to stabilise our economy and fix the financial system*, Centre for Economic Policy Studies, VoxEU.org
5 European Commission, »From financial crisis to recovery: A European framework for action«, COM(2008) 706 final, Brussels.
6 ECB web-site; long-term interest rates.
7 Fritz Scharpf, *Governing in Europe. Effective and Democratic?*, Oxford University Press 1999