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The Global Financial Crisis: Lessons for European Integration

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Abstract

The purpose of this paper is to analyze the various challenges facing European integration and the EU institutional architecture as result of the global financial crisis. The European integration process is not yet complete, both in terms of its content and geographical coverage. It can be viewed as a kind of intermediate hybrid between an international organization and a federation, subject to further evolution. This is also true of the Single European Market and the Economic and Monetary Union, which form the core of the EU economic architecture. Certain policy prerogatives (such as external trade, competition, and the Common Agriculture Policy) are delegated to the supranational level while others (such as financial supervision or fiscal policy) remain largely in the hands of national authorities.

The EU's limited fiscal capacity has proven to be the most critical constraint in being able to respond to the crisis in a proper and well coordinated manner at the Union level. The EU budget is limited to 1% of its GDP and finances only specific policies. The EU cannot borrow or provide credit guarantees. There are several obstacles to coordinating national fiscal policies, which are both of an economic and institutional-political character. So the possibility of implementing a joint fiscal intervention, even for such emergency tasks as rescuing the pan-European financial institutions or member countries in distress, is very limited. These limitations have often led to the nationalization of the fiscal response, including offering emergency rescue packages to troubled financial institutions or non-financial corporations which. This, in turn, has often led to "economic nationalism," which undermines the basic principles of the Single European Market.

The distressed financial markets also test the macroeconomic coherence of the EU and EMU, placing pressure on those countries which are considered financially fragile or potentially insolvent. They face surging risk premia, capital outflow, depreciating currencies, and sovereign borrowing constraints. Again, the EU does not have enough fiscal resources to provide rescue packages, and an increasing number of member-states must apply for IMF assistance.

The best solution would be to increase, at least temporarily, the EU fiscal potential. This would allow providing rescue packages to both troubled financial institutions and member states in a coordinated way. In addition, the EU must act to complete the lacking elements of the Single European market architecture (such as European financial supervision) and help in strengthening global policy and regulatory coordination.

1. Introduction

When the US subprime mortgage crisis erupted in the summer of 2007, few people expected that it could affect the entire world economy so quickly and so drastically. One year later, there was no doubt that we were facing a financial crisis on a global scale with dramatic macroeconomic and social consequences for many regions and countries. This includes the entire European Union, its main trade and financial partners (the US, Japan, China, India and other Asian economies) and the countries in its closest neighborhood (CIS, Middle East and Africa). The global financial crisis has also brought new challenges to European integration and the EU institutional architecture. The EU integration project, which has been progressing successfully for more than half of century, is now facing what is likely to be the most serious sustainability test in its history. In particular, this relates to such crucial components as the Single European Market and the Economic and Monetary Union (EMU). The roots of the tensions that have appeared since the late summer of 2008 can be attributed to the incomplete nature of the EU project and its various asymmetries. Generally speaking, economic integration has advanced much faster than political integration. More specifically, fiscal capacity at the Union level, which is crucial for responding to the crisis, is very limited, and the coordination of national fiscal policies and policy interventions involving national budgets has met numerous obstacles.

This paper's main objective is to provide an early attempt to analyze the challenges mentioned above in various policy spheres, with special attention given to fiscal constraints in conducting effective joint crisis management at the EU level[1]. Where possible, I suggest policy responses or at least the direction they should take.

Before describing the potential repercussions and lessons for European integration from the crisis, I will provide a short analysis of the nature of the crisis and its causes (Section 2) as well as a short historical retrospective of the European integration process in order to understand its institutional asymmetries and limitations (Section 3). This will be followed by Section 4, which contains an overview of the potential challenges and policy traps which the

[1] This is revised and extended version of the paper presented at the 67th International Atlantic Economic Conference, Rome, March 12-14, 2009. While I would like to thank Dr. Hubert Gabrisch from the Halle Institute for Economic Research for his critical and constructive comments to the earlier draft I take a sole responsibility for paper's content and quality.

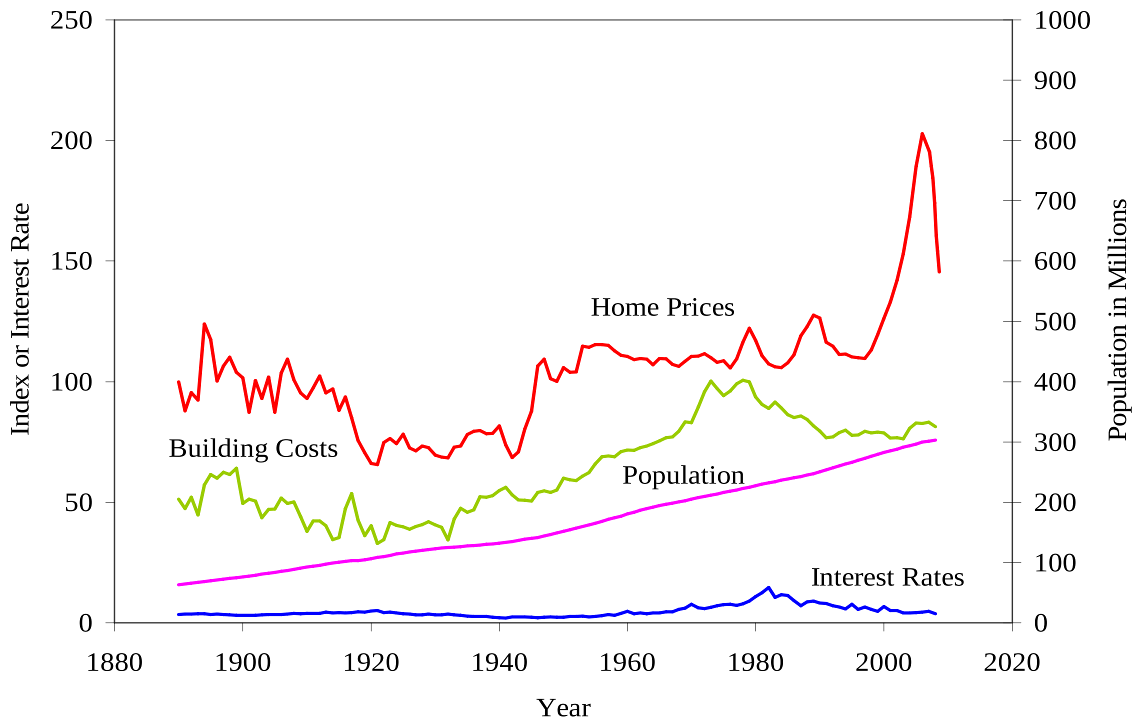
crisis' development and its management has revealed so far in Europe. Section 5 discusses challenges in the fiscal policy sphere and the role of the EU budget, which seem to be crucial for the EU's ability to address various, often unpredictable, crisis challenges. Section 6 focuses on questions related to the future architecture of financial supervision, especially in its European dimension. Section 7 discusses the external policy coordination with other major partners under the existing and (perhaps) newly created global institutions and Section 8 focuses on challenges facing the EU periphery. Section 9 offers a summary of conclusions and policy recommendations, including comments related to the EU's general institutional setting.

This paper is policy-oriented (with some normative analysis) and uses the analytic-narrative method rather than the rigid theoretical modeling or empirical analysis of past trends. I believe it is still too early for the former while the relevance of past trends, especially those illustrating macroeconomic variables and market behavior in the last decade, may be misleading in trying to understand current developments and forecasting for the near and more distant future. For the same reason, the diagnosis, conclusions and potential recommendations offered in this paper have a very preliminary character, and are subject to future verification when we learn more about the crisis and its potential impact on the global and European economy.

2. Characteristics of the crisis

The crisis erupted at the core of the world economy, i.e. in the US-based transnational financial institutions (in the summer of 2007) and spread quickly beyond the US, first to other developed economies (in the first half of 2008), and then to emerging markets (in the second half of 2008 and early 2009). This makes its dynamics and the direction of spillover similar to the Great Depression of 1929-1933 and the 1972 US dollar crisis (which moved from the center to periphery). The movement is the opposite of the 1997-1999 series of emerging market crises, which started at the periphery but then moved to the center, affecting some global financial institutions, which were excessively exposed to the crisis-affected economies.

Figure 1: Case-Schiller House Price Index in the US (in real terms)

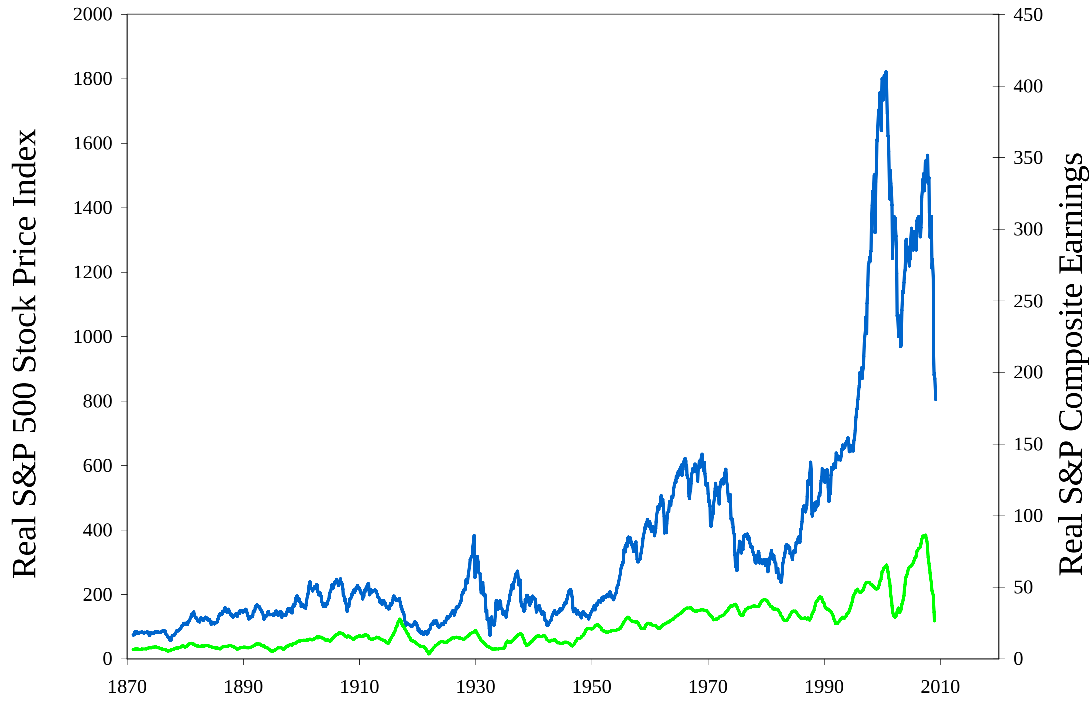


Source: Schiller (2000) and subsequent updates, http://www.econ.yale.edu/~shiller/data/Fig2-1.xls

The current global financial crisis was preceded and caused by an overheating of the world economy, which led, among other things, to the build up and subsequent burst of several assets bubbles (see e.g. Roach, 2009). Figures 1-3 illustrate the three most important assets bubbles which resulted from a buildup in:

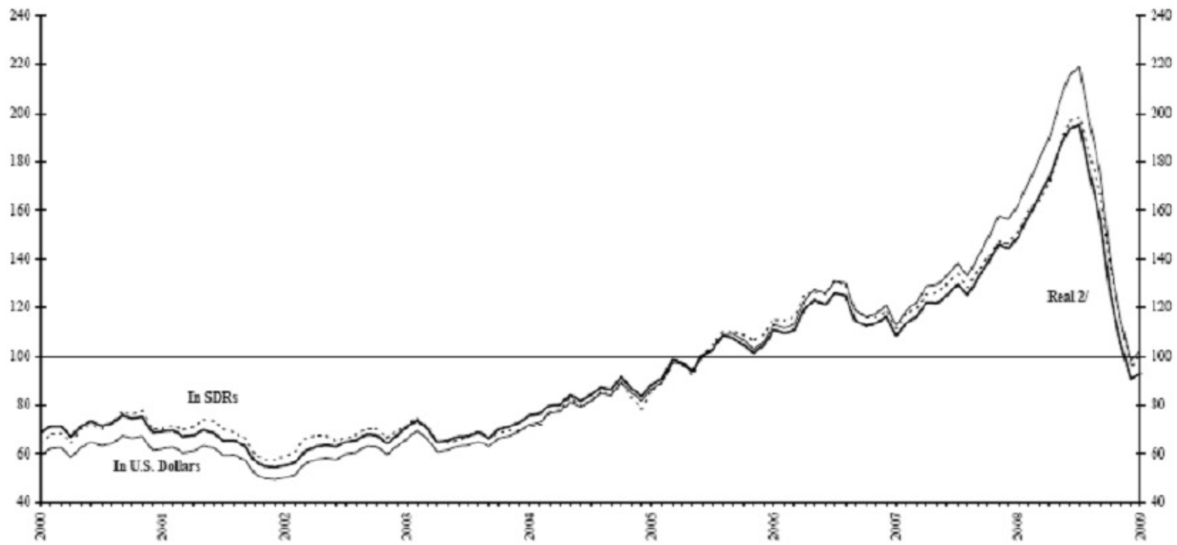
1. The housing and commercial property market in the US and several European countries such as Ireland, UK, Iceland, Spain, Greece and Baltic countries
2. The stock market in the US and over the world
3. The global commodity markets starting with oil, followed by metals, agriculture commodities and food products

Figure 2: Real S&P Stock Price and Composite Earnings Indexes in the US



Source: Schiller (2000) and subsequent updates, http://www.econ.yale.edu/~shiller/data/ie_data.xls

Figure 3: Primary commodity prices, including oil (deflated by US CPI), 2005=100



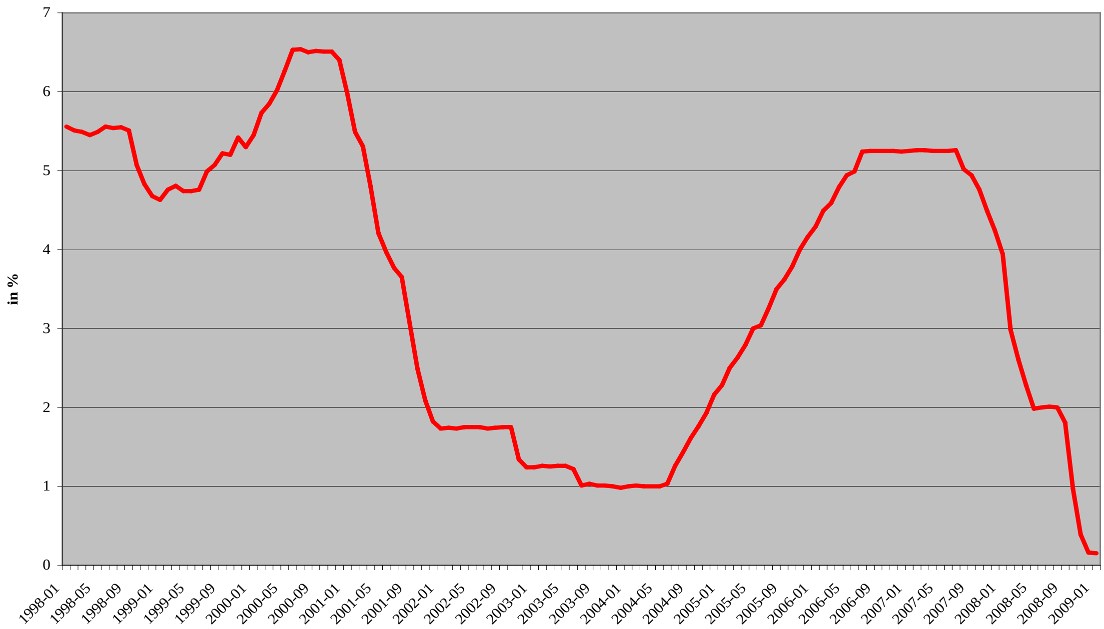
Source: IMF Primary Commodity Prices, http://www.imf.org/external/np/res/commod/chart1.pdf

The exact timing and dynamics of the building up and then bursting of each individual bubble were not the same. For example, when the housing and stock market bubbles had already burst in 2007, the commodity bubble continued to be built up until the summer of 2008, as it absorbed liquidity which fled from the former. This led Orlowski (2008) to suggest a phenomenon of the “wandering asset bubble”. Eventually, however, all of the bubbles burst.

When one takes a step back and tries to identify the factors responsible for the global overheating in the mid-2000s (and therefore for the subsequent crisis), the highly accommodative monetary policy of the US Fed and other major central banks (especially the Bank of Japan) comes to mind as a major scapegoat. Starting in the mid 1990s, most central banks in the developed world, which were enjoying record-low inflation and low inflationary expectations, reverted to a more intensive fine-tuning in order to avoid the smallest risk of recession.

As a result, the Fed aggressively reduced its interest rate three times over the last 10 years (see Figure 4), starting with the series of crises in emerging markets (Mexico, South-East Asia, Asia, Russia, and Brazil) which caused the Long Term Capital Management troubles in the US at the end of 1998. This was followed by the 2001-2002 drastic interest rate cuts (which were lowered to 1%) which followed the bursting of the dotcom bubble and the 9/11 terrorist attacks. On both occasions, the Fed provided relief to troubled financial institutions, helping to circumvent (1998) and reduce (2001) the danger of a US recession, while at the same time, fueling global economic growth. The third intervention occurred in the wake of the current crisis (at the end of 2007 and the beginning of 2008): the federal funding rate was reduced from 5.25% to 2% within a few months span and then further reduced to a record-low of 0.15% in December 2008.

Figure 4: Fed Federal Funds Effective Rate, in %, 1998-2009



Source: http://www.federalreserve.gov/datadownload/

Fearing recession and deflation (in the early 2000s)[2], the subsequent tightening of monetary policy always came too late. Such an excessively lax Fed attitude contributed to a systematic build up of excess liquidity in both the US and around the world. The additional contribution came from of the somewhat mercantilist policies of several emerging-market exporters, who preferred to keep their exchange rates undervalued and continued to accumulate large international reserves, finally reaching record-high levels (as in the examples of China and India). The sources of such policies can be traced to both a tradition of export-led growth strategies conducted by the earlier generation of "Asian tigers" (from 1960s to 1980s) and lessons drawn from a series of emerging market currency crises in the 1990s. The IMF recommendations to build large precautionary foreign-exchange reserves worked in the same manner. At a later stage, the rapidly growing trade and fiscal surpluses of the oil-exporting economies such as the Gulf States or Russia added to this trend.

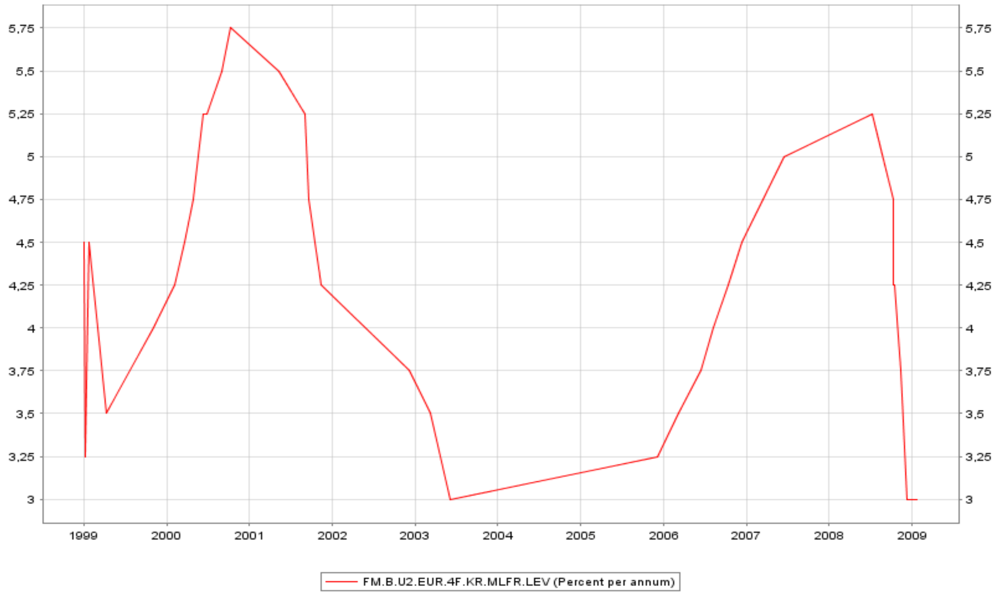
The growing volume of international reserves reflected a growing global liquidity[3], on the one hand, and allowed for the balancing of the massive current account deficit of the US, on the other. This means that the controversy of whether the "global savings glut" (Bernanke, 2005) or "global liquidity glut" (see Gros et al., 2006) was responsible for the growing international imbalances was probably incorrectly formulated because these were, in fact, two sides of the same phenomenon.

One of the most interesting questions is why the inflationary consequences of such super-expansionary policies came so late and in such a relatively moderate scale? Several hypotheses are worth further analytical exploration.

[2] This fear was well articulated by Greenspan (2004) and his idea of a "risk management approach" to monetary policy.

[3] This is perhaps the only available measure of "global liquidity" or "global money supply". Nevertheless, both categories require further theoretical and statistical conceptualization before they can be used for analyzing global macroeconomic and financial developments.

Figure 5: ECB marginal lending facility, in %, 1999-2009



Source: http://sdw.ecb.europa.eu/browse

First, the positive supply-side shocks triggered by market transformation in many developing and post-communist communist countries and the global trade liberalization of the 1990s (with some effects delayed to the first half of 2000s[4]), placed downward price pressure on the global manufacturing market. Second, rapidly growing international trade and financial transactions meant increased demand for USD and EUR as global transaction currencies. Third, many emerging-market economies enjoyed a rapid post-inflationary re-monetization backed by increasing international reserves. Finally, the above mentioned asset bubbles absorbed part of the excess liquidity while the increase in asset prices was not usually reflected by the standard inflation indicators such as CPI or PPI.

In comparison with the Fed, the monetary policy of the European Central Bank was less expansionary, which is reflected, for example, in less dramatic interest changes in times of distress (see Figure 5). At the beginning of the current financial crisis, the ECB even tried to "lean against the wind", increasing its basic interest rate in June 2008, against the concern of growing global inflationary pressure. However, its room of maneuver was always quite limited and determined, to a large extent, by US monetary policy decisions. And only very recently was the ECB able to bring the Eurozone's inflation below the statutory ceiling of 2%.

[4] For example, the Agreement on Textiles and Clothing, which was an important part of the 1994 GATT/WTO global trade liberalization agreement, entered into force only on January 1, 2005.

3. European integration: its institutional asymmetries and limitations

The European integration process started with the Rome Treaty in 1957, which created the European Economic Community of six Western European countries. This process does not have any historical precedents in contemporary history. Its political aim was to put a stop, once and for all, to the dramatic experience of many centuries of bloody conflicts in Europe which culminated in two world wars, and to build the economic foundations for peace and prosperity on the continent. It is based on the principle of voluntarily delegating a level of national sovereignty to the Community/Union level.

This meant that each Treaty revision aiming to either delegate new prerogatives to the Community/Union level or bring new countries to the "club" required the unanimous agreement of all member states. This was often difficult to achieve. So the integration process progressed step-by-step, depending on the consensus on particular issues and available cross-country compromises. To be able to move forward and secure unanimity, each time a majority had to grant outsiders/Euroskeptics concessions, including many exemptions and opt-outs from common rules in almost each area of EU integration. The EMU and Schengen zone, which do not cover all EU members, are the best examples of such opt-outs.

As result, the EU represents a hybrid construction with many institutional asymmetries. It does not fall under any simple definition such as a federation, confederation or international organization. Integration went relatively far in the common trade policy area, and in various areas of regulation related to the Single European Market, Schengen area, and common currency (although in all these spheres, regulatory harmonization is not yet complete). On the contrary, in the political arena, the integration process has not advanced very far. This is reflected in the reluctance of member states to transfer more financial resources to the Union level, even in case of emergency, as is being experienced under the current crisis.

Asymmetries in the integration architecture did not create serious tensions in "tranquil" times. This changed, however, when the European economy became exposed to the unprecedented series of shocks generated by the global financial crisis.

4. Europe's response to the crisis: potential threats to the Single European market

Europe's response to the crisis came quite late and not always in a well coordinated way. In its first phase (until the late summer of 2008), the danger of systemic financial crisis was downplayed by most policymakers. The periodic liquidity squeezes on the inter-bank market were considered a temporary contagion effect imported from the US. The main policy concerns were the appreciation pressure on the Euro (generated by a depreciating US dollar), the weakening US demand for EU export, the continuing inflationary pressure and the decline of the housing market in some EU countries.

The breaking point came with the Lehman Brothers bankruptcy in mid-September 2008. This dramatic event triggered a far-reaching contagion effect on world financial markets and global financial disintermediation. It also revealed the many systemic weaknesses of the European financial institutions, whose situation did not differ so much from their US partners and competitors. It became apparent that European banks and other financial institutions were also heavily exposed to various "toxic" assets, which originated both domestically and were acquired in the US, and generally overleveraged.

The policy responses were quite chaotic and mostly on the national level, in spite of their cross-border consequences. Because most of them involved either explicit or implicit fiscal consequences, they had to be taken by national authorities, due to the limited, in fact almost non-existent, fiscal capacity at the EU level. The attempt to coordinate national anti-crisis policies came late and was not always efficient or successful. The main factors which greatly complicated policy coordination were the various speeds and strengths of cross-country financial contagion, the uneven exposure of individual economies to shocks, the uneven capacity and resources to provide rescue, the sometimes hasty and nervous reactions on a national level and the temptation to free ride. These led to many beggar-thy-neighbor policy decisions and, more generally, to economic nationalism. This challenged the basic principles of the Single European Market, the core of the EU economic and institutional architecture.

Examples of beggar-thy-neighbor policies, economic nationalism and free riding included, among others, cross-border competition in providing emergency deposit guarantees (initiated by Ireland), the Iceland-UK "war" on rescuing troubled Iceland banks and their international depositors (see Vives, 2009), poorly coordinated rescue packages for some transnational banks which led to their break up along national lines (the Fortis example)[5], emergency aid packages to some great manufacturing companies limited to national borders (the example of French support to car producers; see EurActive, 2009, Feb. 10), measures discouraging cross-border movements of labor, various regulatory actions of financial supervision focusing on the liquidity and safety of individual national markets rather than the cross-border impact of their decisions, etc. If this trend continues, it could lead to serious disruption on the Single European Market in its many important segments. An even greater challenge is posed by the anti-crisis fiscal policies per se which are the subject of the next section.

5. Strengthening EU fiscal capacity

The global economic downturn has renewed interest in a counter-cyclical fiscal policy going well beyond the automatic fiscal stabilizers (see e.g. IMF, 2008). The idea itself is highly controversial and raises several reservations (see Balcerowicz & Rzonca, 2008). One reservation is whether a fiscal stimulus could work effectively in an environment of disrupted financial intermediation (one of the reasons why the monetary stimulus has had a limited impact). Another is the question of what will be its medium-to-long-term impact on the level of public debt, which is high in several countries (most of them facing additional challenges related to population aging). This general debate is, however, beyond the agenda of this paper.

I would like to discuss the EU-specific challenges related to any large-scale fiscal activism, which are sometimes necessary in order to rescue troubled financial institutions or member states. As mentioned before, the EU's own budget resources are very limited (in the range of 1% of GDP) and are strictly targeted to support some key policies at the level of the Union, mainly the Common Agriculture Policy, the Cohesion Policy, R&D programs, and official development assistance. The only possible window of anti-cyclical policy relates to the more intensive, short-term use of the Cohesion Fund, structural funds and European Investment Bank (EIB) resources to support less developed regions, mostly in the EU new member states (NMS). This measure was included in the European Economic Recovery Plan

[5] For examples and a timeline of uncoordinated or poorly coordinated rescue attempts of financial institutions in the autumn of 2008, see Lanoo (2008).

approved by the Council of the European Union (2008) during its summit in Brussels on December 11-12, 2008[6].

The idea of creating additional ad hoc funds at the EU level, in order to provide rescue to troubled financial institutions (Gros & Micossi, 2009),[7] has not received widespread support among member states. Therefore the only remaining option is coordinating the national fiscal stimulus packages. However, such coordination cannot be effective for several reasons:

1. Fiscal decisions remain within the prerogatives of national governments and national parliaments. None of the EU governing bodies (the Council, European Commission and European Parliament) has the formal power to force a member state to participate in a joint fiscal stimulus package and deliver on given promises. In fact, smaller member states may face the temptation of free riding, i.e. benefiting from a stimulus offered by larger partners while remaining reluctant to contribute to a common pool.
2. On the contrary, all EU member states are subject to limits in their fiscal deficit (3% of GDP) and public debt (60% of GDP on gross basis) imposed on them by the Treaty and the Stability and Growth Pact (SGP). As most of the countries have run cyclically adjusted deficits over the last decade, they do not have much, if any, room for countercyclical fiscal policy. So it was not surprising when shortly after agreeing on an EU-wide fiscal stimulus package, the Commission initiated the “excessive deficit” procedure against six member states (France, Greece, Ireland, Latvia, Malta and Spain)[8], which had breached the 3% of GDP deficit ceiling in 2008 and which appeared likely to have expanding deficits in 2009 and 2010. Looking ahead, this kind of schizophrenia will not enhance the credibility of any voluntarily agreed upon fiscal-stimulus package. Rather, it further undermines EU fiscal surveillance rules and thus has hardly built a culture of fiscal constraints on national level.
3. In addition, at the start of the current crisis, individual EU member states started to face highly uneven public borrowing constraints determined by many factors, the fiscal prudence past track record probably being the most important one. The atmosphere of collective safety provided by a common currency in the first ten years

[6] However, its implementation may face several obstacles. So far, the absorption level of structural and cohesion funds in EU NMS was not particularly high due to various capacity constraints. The economic downturn can additionally decrease the available pool of economically effective projects and the domestic sources of their co-financing.

[7] A similar idea was offered by the Government of France at the end of September 2008; see EurActive (2008, Oct.2).

of its existence is gone (probably for good). To address this issue the long discussed idea of common Eurozone bonds (e.g. Giovannini et al., 2000) became a policy interest again (EurActive, 2008, Sept. 25; 2009, Feb. 18). However it has little chance of being approved both by EMU countries with a lower risk rating (who are reluctant to pay more for their treasury securities when the risk will be shared at the EMU level) and those member states which remain outside the Eurozone (who are afraid of being crowded out from the sovereign debt market – see below).

4. Borrowing constraints are of particular concern for those EU member states (especially among the NMS) which remain outside the Eurozone. Neither the EU nor even EMU membership is considered an effective insurance against sovereign default by financial markets. As a result, the room for fiscal maneuver for at least half of the member states is also highly limited for this reason.
5. Furthermore, even if one assumes that for the reasons elaborated in the three previous paragraphs that the national contributions to a joint fiscal stimulus package must remain asymmetric, (i.e. mostly provided by countries which have room for maneuver under the SGP and lower borrowing costs, which does not seem likely for domestic political economy reasons – see below), this could cause a further crowding out of resources available for countries with poorer credit ratings.
6. Because of the expected lack of solidarity in fiscal stimulation[9] caused by the above mentioned policy and institutional constraints, the national fiscal stimulus packages will be maximally targeted to domestic economies and will disregard potential adverse cross-border effects. This can be easily understood from a political economy point of view. If a government wants to spend more of its taxpayers' money (most likely at the cost of burdening future generations of citizens with additional debt), why should the benefits of such policies be shared with other nations? This is the main source of "economic nationalism" which may seriously undermine the Single European Market and trigger a dangerous wave of a new kind of protectionism worldwide.

Regardless of the debate on whether or not countercyclical fiscal policy makes sense at all, and if so, to which extent and in which concrete forms, the current crisis has made clear that increasing the fiscal capacity at the Union level is of critical importance. At the very least, this

[8] In addition to the ongoing excessive deficit procedure against Hungary and UK - see http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm.

[9] Saha and von Weizsacker (2009) estimate that the expected discretionary loosening of fiscal policy by individual member states in 2009 will be highly uneven, ranging from nil (in the cases of Denmark, Ireland and Italy) to almost 6% of GDP (in the case of Spain). A similar picture is provided by Prasad & Sorkin (2009) in respect to the G-20 countries.

would help member states to avoid implementing beggar-thy-neighbor policies, various forms of "economic nationalism" and free riding.

First, the lesson taught by the Great Depression is that public authorities must step down in large-scale financial crises to avoid a systemic banking crisis and the total collapse of the financial system, and the resulting deep recession spiral[10]. While private sector and market-oriented solutions should always be given priority, injecting public money is often unavoidable, at least temporarily. If this could be done at the EU level, it would help in avoiding the breakup of transnational financial institutions along national boundaries, distorting the European financial market, breaching the single European competition policy, moving speculative pressures from one country to another and forcing some member countries to act beyond their financial means (as in the case of deposit guarantees - see Vives, 2009).

Second, as recent experience demonstrates, some EU member states may require external financial support to either resist speculative attacks against their currencies or sovereign debt default, or both. The EU should independently be able to provide this support, rather than only being able to do it by coordinating the support of individual member states or by backing IMF programs.

Even such a limited agenda requires more fiscal resources than are currently available under the EU budget framework. However, in order to increase fiscal capacity at the Union level, further changes in EU treaties, going beyond the Lisbon Treaty (which is still awaiting ratification), will be required[11]. Any substantial increase in the size of the EU budget will have not only fiscal implications on a national level (increasing the size of the national contribution to the EU's budget and additional revenue sources at the Union level) but is also likely to have far-reaching implications for Europe's political architecture (increased federalism, with more power given to the European Parliament and weakening the veto power of member states).

[10] The very nature of the fractional banking/financial system – the high level of leverage and time mismatch between assets and liabilities (borrowing short in order to lend long) makes the entire financial system extremely vulnerable in times of distress and crises in confidence. The collapse of one large bank or investment fund may cause a far-reaching chain reaction as experienced recently after the bankruptcy of the Lehman Brothers.

[11] Before this happens, one can imagine building ad hoc emergency funds.

6. Building the single European financial market and rescuing the European financial sector

Monetary, or more broadly, macroeconomic policy, is not the sole scapegoat when one analyzes the roots of the current crisis. Regulations and regulatory institutions that remained well behind rapid financial market developments also played a role. Two major inconsistencies are particularly apparent when looking at institutional issues:

- The global character of financial markets and the transnational character of major financial institutions as opposed to the national mandate of financial supervisions. This inconsistency can be observed at the European level as well: the Single European Market of financial services does not have any kind of financial supervision authority at the EU level (see analysis of Veron, 2007; Vives, 2009).
- The increasing role of financial conglomerates operating in various sectors of the finance industry and the innovative, cross-sectoral financial instruments versus the sectoral segmentation of financial supervision; only a few countries can allege consolidated financial supervision. The US presents additional institutional peculiarities with two levels of responsibilities (federal and state) for financial supervision.

Some blame should also be borne by the rating agencies and supervisory authorities that failed to understand the nature of the innovative financial instruments which provided excessively short-sighted risk assessment by not sufficiently taking the actual risk distribution in the long intermediation chain between the final borrower and creditor into account, thus underestimating the actual risk[12]. The same rating agencies which gave financial institutions and individual financial instruments excessively positive grades during the boom started to hastily downgrade their ratings in times of distress, which added to market panic.

Precautionary regulations, usually meant to enhance the safety and credibility of financial institutions such as capital-adequacy ratios (especially when assets are risk-weighted and liabilities mark-to market priced) or tight accounting standards related to reserve provisions against expected losses, also unveiled their perverse effect as they led to sudden credit stops and massive fire selling of assets. They proved be strongly pro-cyclical (with Basel-2

[12] See Soros' (2009a) comments on the wrong perception and the resulting inaccurate risk assessment of the credit default swaps (CDS).

being even more pro-cyclical than Basel-1), especially after the crisis had already erupted (see Goodhart, 2009).

Finally, the incentive systems under which many financial institutions and their management operated led to shortening their analytical and decision-making horizons and serious distortions in adopted business strategies. Some popular topics discussed recently in the media such as the aggressive system of bonuses linked to short-term paper profits, the large redundancy packages for top management (even if they are evidently failing) or the remuneration of rating agencies by clients whom they evaluate are only the tip of the iceberg.

In the thematic context of this paper, the most important question relates to potential EU institutional and policy responses to the systemic inconsistencies mentioned above.

As previously noted, the EU does not have the fiscal capacity to conduct rescue operations for the troubled transnational financial institutions. This forces the institutions to seek support at the national level with the risk of refocusing their business back to individual national markets. This dilemma is unlikely to be resolved without far-reaching changes to the Treaty.

The situation is a bit simpler with European financial market regulations and supervision, at least in terms of the Treaty. These competencies are potentially within the Single European Market mandate delegated to the level of authority of the Union and can be regulated by the Council through a qualified majority voting. However, there is a lot of resistance to pan-European supervision on a national level, especially in countries where the financial industry plays a substantial role (such as the UK). Some of the arguments sound legitimate: as long as national budgets are responsible for providing rescue operations, supervisory power cannot be delegated to a supra-national body (see Goodhart, 2009).

The recently released report of the High-Level Group on Financial Supervision appointed by the President of the European Commission (De Larosiere et al., 2009) attempts to address many of the regulatory and systemic flaws in a comprehensive manner, both at the European and global levels. It offers several recommendations aimed at harmonizing and strengthening the European regulatory standards, not only in respect to "mainstream" financial institutions such as banks or insurance companies, but also to investment and hedge funds. It also calls for setting up a new body called the European Systemic Risk Council (ESRC), which "...*should be composed of the members of the General Council of the ECB, the chairpersons of CEBS, CEIOPS and CESR as well as one representative of the European Commission*" and chaired by the ECB President. The role of ESRC would be to pool and analyze macroeconomic information related to financial stability. When appropriate, the ESRC would issue macro-prudential risk warnings to respective decision-making and supervisory bodies.

In respect to an institutional architecture of financial supervision, the Larosiere Report seems to offer a half-way solution in comparison to the earlier expert-type proposals (see e.g. Lanoo, 2008). The report suggests creating a set of coordinating bodies at the EU level while retaining most of the prerogatives of national authorities in the day-to-day operational supervision. More specifically, it recommends setting up a European System of Financial Supervisors (ESPS) involving three European supervisory bodies (in the banking sector, the insurance industry and the securities market) which would coordinate national supervisors. In addition, colleges of supervisors would be set up for all major cross-border financial institutions. It also suggests a four-year transition period to make the proposed reform operational.

The Larosiere Report is justly criticized for the slow proposed pace of creating the ESPS, the limited powers this body would have, keeping the three sectoral supervisions separate, separating macro (ESRC) and micro supervision (ESPS) and the lack of bail out facilities at the EU level (see Lanoo, 2009; Vives, 2009).

However, it remains to be seen whether even a modified version of the Larosiere recommendations will receive sufficient support from member states in order to be translated into concrete decisions and binding regulations. The stakes are very high: if the EU member states fail to agree on building a pan-European financial supervisory authority, there will have to be greater control over transnational corporations in each host country (as predicted by Goodhart, 2009) which could translate to more beggar-thy-neighbor policies in the future.

7. The EU role in addressing global macroeconomic and fiscal challenges

As mentioned earlier, the crisis is truly global in character, so the policy response should also be global. Even the most comprehensive and adequate decisions within the EU (which is, unfortunately, not always the case as argued in the previous sections) would remain ineffective without broader policy coordination with the other major players. Furthermore, as one of the economic superpowers, the EU bears a special responsibility for global crisis management.

In the thematic context of this paper, I will concentrate on highlighting key issues and policy dilemmas facing the EU as a global player:

1. The urgent task of overhauling financial regulations and financial supervision discussed in the previous section cannot be limited to EU jurisdiction. Many important questions such as revising the Basel prudential regulations (reducing their pro-cyclicality) and accounting standards, imposing a regulatory corset on hedge and investment funds, correcting the role of credit rating agencies, fighting tax and regulatory havens, regulating and supervising global financial conglomerates, and monitoring macroeconomic and macro-prudential risks require close cooperation at least within the OECD "club." Bringing key emerging market players on board would also be highly recommended. The De Larosiere report highlights the importance of global coordination on these issues and actively offers several interesting ideas in respect to both the content of global financial regulations and their institutional setting.
2. The same concerns the global coordination of macroeconomic policies. While political realism prevents us from considering a global economic government, a global currency or a global central bank,[13] increasing dialogue, consultation and policy coordination on a global level is both possible and desirable. The EU can take the lead in pursuing such a process, drawing on its own integration experience as a reference. One can also imagine authorizing the IMF to issue additional liquidity in the form of SDR to provide emergency support to countries in distress (see Soros, 2009b). This could disentangle, to a certain extent, the management of global liquidity from the monetary policies of the largest central banks such as the Fed or the ECB. The question remains regarding what would be the market acceptance of SDR, if it were issued in large amounts.
3. In the context of the two previous paragraphs, strengthening the IMF's role seems to be extremely important. The "gold" era of economic growth in the early and mid 2000s and the unique calm on global financial markets (which in retrospect was probably indicative of the silence before the storm) drastically decreased the demand for IMF lending and led to its institutional downsizing. This unfortunate trend must be now rapidly reversed and the IMF mandate should be amended and strengthened. Apart from country-targeted macroeconomic rescue programs and macroeconomic and financial surveillance, this institution should play a much greater role in monitoring global risks and providing a technical platform for global policy dialogue

and coordination. However, this brings back the issue of the IMF's institutional structure, and especially the redistribution of voting power between developed and developing countries (in favor of the latter) to enhance its legitimacy. The EU could play a crucial role here in many respects. First, it could give up part of its voting power in favor of developing nations and reduce its number of seats on the Executive Board. This could be done by consolidating the EU country quotas and EU countries' representation into a single constituency, a move which was already suggested a long time ago (e.g. Fischer, 2006). Second, it could give up its informal "monopoly" on nominating the IMF Managing Director, again in favor of one of the developing nations. Third, it could actively contribute to the recapitalization of the IMF and to increasing its lending capacity. The decisions taken by the European Council on March 19-20, 2009 seem to be moving in this direction, at least in relation to the first and third proposal (Council of the European Union, 2009, Annex 1, paragraphs (viii) and (ix), p. 15).

4. The EU could also play a leading role in bringing the stalled global trade negotiations (the so-called Doha round) to a successful outcome (as declared at the G-20 meeting in Washington DC in November 2008). This would be an important anti-protectionist message to the entire world economy and a bold policy measure which would help stop the global recession. Such a mission would probably require more flexibility on the EU side in respect to agriculture trade.
5. The EU must also continue its role as the largest provider of development assistance to lower-income countries. This is even more important now than a few years ago because the global economic downturn and the sudden stop in private capital flows have severely strained developing economies.

8. Challenges to the EU periphery

The crisis developments have made clear that financial markets are not going to continue to consider the EU as a homogenous area which is immune to adverse and country-specific macroeconomic and financial shocks. On the contrary, despite its origins in the US and the richest EU countries, the financial crisis affected the EU periphery more adversely than its core. The rapidly declining stock markets, increasing risk premia for both sovereign and private borrowing, declining currencies (especially in countries which run flexible exchange rate regimes) and sometimes also banking sector troubles (in the cases of Hungary and

[13] However, a lot would depend on the readiness of the largest central banks to accept SDR as a reserve currency.

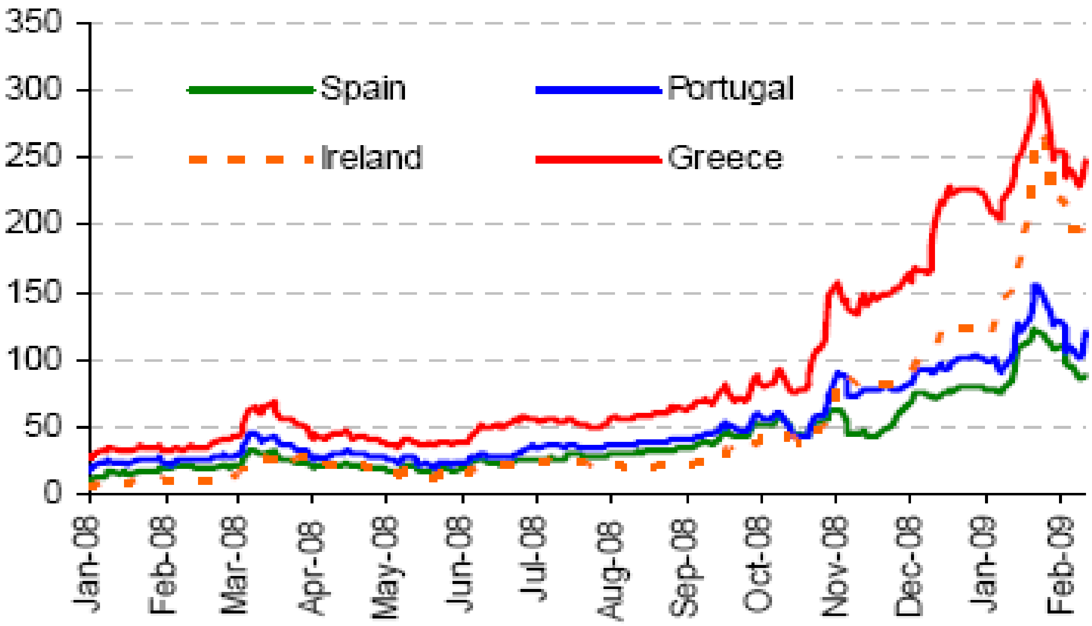
Latvia) are the phenomena which the governments and monetary authorities of the EU NMS, EU candidates and EU neighboring countries have been facing since the summer of 2008.

To provide a correct diagnosis, a broad notion of EU "periphery" requires certain disaggregation. One could say there are three tiers of EU peripheries:

1. Certain EMU countries (especially in the Northern Mediterranean region) with weaker macroeconomic fundamentals, especially in the public finance sphere
2. Those NMS which do not belong to the EMU yet
3. EU actual and potential candidates, members of the EEA, and key EU European neighbors

The main problem of the first group is their high risk premia and, therefore, high spreads for government bonds (when compared with yields on bonds issued by Germany and other countries considered to be the EMU "core" – see Figure 6), a phenomenon which was not observed in the first ten years of the Eurozone's existence. This signals a possibility that financial markets can further test fiscal solidarity within the EMU, i.e. the readiness of the core to provide a bailout to the troubled periphery, in order to avoid the precedent of sovereign default within the Eurozone. Looking ahead, however, higher spreads in respect to poor fiscal performers can offer an additional disciplining mechanism on top of a rather soft and partly diluted SGP (see Dabrowski, Antczak & Gorzelak, 2006).

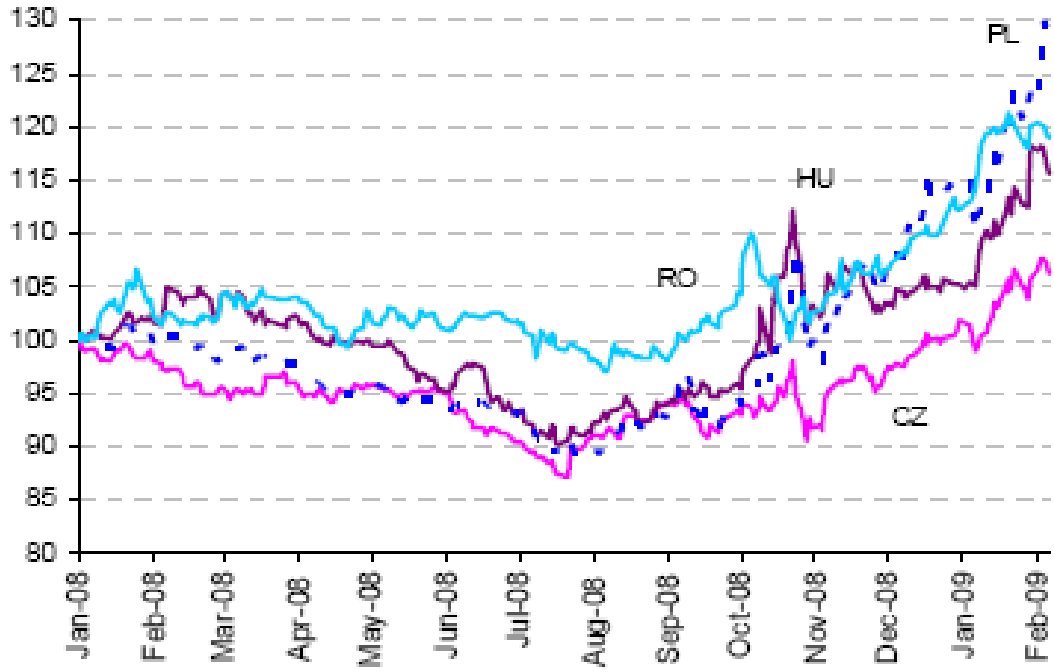
Figure 6: Government Bond Spreads over German Bund in some EMU countries



Source: EU10 (2009), p.6

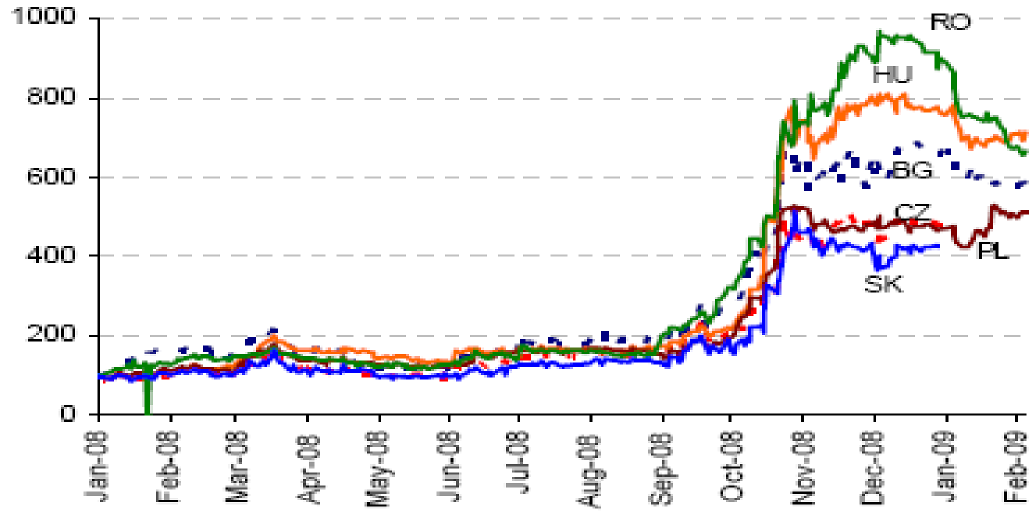
The variety of potential risks is much broader in the second and third groups. The risks include exchange rate and other financial and macroeconomic risks related to exchange rate volatility, i.e. the risk of currency mismatches in the corporate and financial sectors and general government finances, which may result in their insolvency. With shrinking global liquidity and increasing risk aversion (especially after the Lehman Brothers' bankruptcy), these two groups of countries have become the subject of intense market pressure (see Figures 7-8) and resulting capital outflow.

Figure 7: NMS Exchange Rates against the Euro (Jan. 2008 = 100)



Source: EU10 (2009), p. 8

Figure 8: Euro Emerging Market Bond Index Global (EMBIG) Spreads



Note: The difference between the yield on each bond and a Euro government yield of the same maturity, duration weighted.

Source: EU10 (2009), p. 8

This proved to be a drastic change in comparison with the previous 7-8 years when this part of the world enjoyed the reputation of being a safe "haven". In particular, this related to the EU NMS (the second group), where risk premia were below those of other emerging markets (Luengnaruemitchai & Schadler, 2007). However, starting in the second half of 2008, the situation changed dramatically. Three NMS (Hungary, Latvia and Romania) have already had to resort to using IMF-led international rescue packages. The remaining countries are struggling to avoid a similar scenario, which would be considered a serious blow to their reputations. It appears that financial markets have revised their previous overly optimistic assessment of this region and they are not ready to continue considering EU membership itself (without joining the EMU) as a firm insurance against a financial crisis. Also, the unilateral peg to the Euro, even in the form of long- and well-functioning currency boards as in the cases of Estonia, Bulgaria and Lithuania is not considered as a fully credible mechanism by financial markets any longer.

The analysis of macroeconomic developments in the NMS after their accession to the EU is beyond the agenda of this paper. However, one should mention the widespread "reform fatigue" experienced by these countries after a decade of intensive transition- and EU-accession-related modernization efforts, their reluctance to correct deep fiscal imbalances (Hungary and Poland) and their inability to contain excessive private credit expansion (the case of the Baltic states). In a sense, the NMS became the victims of their own success and the post-Enlargement euphoria (both global and regional) of private investors, researchers and analysts, national authorities and EU governing bodies, who had greatly underestimated the magnitude of the potential risks.

Part of the above story relates to the slow pace of EMU enlargement, a process which encountered several obstacles on both the incumbent and candidate sides. Politically, the incumbents are in no hurry to admit the new member states to the “inner” club, as this allows the incumbents to maintain a “carrot” which can be given or withheld from the NMS depending on their behavior. The incumbents’ economic fears were mostly related to the controversial hypothesis that the accession of rapidly-growing countries would result in an increase in inflationary pressure and interest rates in the Eurozone, which would have an additional contractionary impact on the slower-growing economies of some of the incumbents (see Rostowski, 2006; Zoubanov, 2006).

To address these fears, priority was given to those NMS with higher GDP per-capita levels, even if some of them (such as Cyprus and Malta) did not meet the public debt criterion. On the other hand, the two best performing and fiscally prudent economies (Estonia and Lithuania) which *de facto* already belonged to the Eurozone (by running Euro-denominated currency boards) were rejected in 2006 because they did not meet the inflation criterion (by 0.1 percentage point in case of Lithuania). The crisis management in these two countries could have been made easier, if they had been admitted to the EMU in 2006. Blocking Bulgaria’s application to enter the ERM2 mechanism for the last two years is another example of the same policy, which was meant to discourage NMS from rapidly entering into the EMU. This means that the EMU enlargement policy on the incumbent side was guided by “real convergence” criteria rather than the nominal convergence criteria as defined by the Treaty.

The largest NMS (the Czech Republic, Hungary, Poland and Romania) were also in no hurry for various reasons, including the lack of political determination to conduct fiscal adjustment, the euro-skeptical ideologies of major political forces and the discouraging signals from the incumbents. The post-enlargement euphoria and the low risk premia made the potential economic benefits of early Euro adoption less apparent.

As a result of this double skepticism (both on the incumbent and candidate side), most of the NMS are now experiencing financial crises, which was the worse-case scenario predicted a few years ago by those who warned against the “no rush” policy (Dabrowski, 2007). Some of the crisis victims (such as Poland and the Baltic countries) are trying to seek a way out of the current turmoil by setting a realistic EMU accession date and aiming for immediate ERM2 accession (Poland).

The third ring of periphery countries (i.e. EU actual and prospective candidates, members of the European Economic Area and EU neighbors in the CIS) are also experiencing a difficult time, with some of them (Iceland, Ukraine, Belarus, Armenia, Georgia, Kyrgyzstan and Serbia) being forced to ask for IMF rescue and others continuing to struggle based on their own means (like Russia and Turkey). The potential importance of each country case depends on its economic potential and economic relations with the EU, on the one hand, and on its formal status in respect to potential EU accession, on the other. Obviously, the EU obligations and political interest to provide help and rescue to the actual and potential EU candidates are greater in comparison with other neighbors.

So far, in spite of many alarming public comments (like that of the World Bank President Robert Zoellick on February 27, 2009[14]) there is no coherent action plan at the Union level on how to stop financial contagion from spreading across the EU periphery. Several ad hoc measures have been taken since October 2008, when the crisis started to hit emerging markets (see Darvas & Pisani-Ferry, 2008 who analyze some of these measures in respect to NMS). However, as in other policy areas, the shortage of fiscal resources at the EU level has limited the scale and effectiveness of anti-crisis measures. Formally, the EU co-sponsored some country-specific rescue programs (in the cases of Hungary, Iceland and Latvia; the same will probably happen in respect to Romania) but most of resources came from either multilateral institutions such as the IMF and World Bank, or directly from the EU member states.

One of the key questions which the core Eurozone members must answer is whether offering a fast-track EMU accession opportunity to countries that remain outside the common currency area (which could help revive market confidence and incentivize them to adjust policies) is a better solution than allowing them to continue sinking into market turmoil.

The same question concerns increasing the speed of the EU accession process in the Western Balkan countries and Turkey. This which could potentially help the Western Balkans and Turkey in way that is similar a clearly defined EMU accession perspective encourages the current NMS to act.

[14] http://www.ft.com/cms/3cf2381c-c064-11dd-9559-000077b07658.html

9. Looking ahead: how to make future crisis management more effective?

The European integration is not a completed project, both in terms of its content and geographical coverage. Actually, the EU represents a kind of institutional hybrid (subject to further evolution) based on asymmetric foundations, which cannot be easily attributed to a single institutional model such as a federation, confederation or international organization. Generally it has more prerogatives in the economic sphere than in the political one.

The above mentioned asymmetry (or hybrid character) concerns even the Single European Market and Economic and Monetary Union, which constitute the main pillars of the EU economic architecture. Some prerogatives such as the external trade policy, the Common Agriculture Policy, and the competition policy are delegated to the supranational level while others (like financial supervision or fiscal policy) remain largely in the hands of national authorities.

Although the financial services represent one of the most integrated parts of the European and global markets, they are supervised by national authorities and financial regulations are not fully harmonized across the EU. While a substantial part of the EU uses the common currency, the Union budget is limited to 1% of its GDP and finances only specific policies. So there is very limited room for a joint fiscal policy at the Union level. The list of institutional inconsistencies, and sometimes even contradictions, is a long one.

Such an adverse shock as the current global financial crisis will serve as an important test which will measure the consistency and sustainability of the EU institutional architecture and common policies. It may either strengthen them and trigger further integration (by eliminating asymmetries and adding the lacking integration segments) or put the entire European project in reverse, by renationalizing certain policies. Without assuming which scenario is more likely to occur, the following dangers and challenges should be pointed out at this early stage of crisis development:

1. The greatest danger is related to counter-cyclical fiscal policy conducted at the national level. This involves a great potential for protectionism or economic nationalism, which would easily destroy several segments of the Single European Market. It could also destroy the SGP and the fragile culture of budgetary constraints at the national level. Due to the crowding-out effect, it would further decrease the

available financing for both private sector and sovereign borrowing at the EU periphery.
2. The same kind of danger comes from national rather than EU-wide rescue packages offered to the troubled financial institutions.
3. The entire system of financial regulation and financial supervision requires a general overhaul both at the global and EU levels. The available blueprints, including the Larosiere Report, are moving in the right direction, but it remains unclear whether their recommendations will receive sufficient political support from national governments as they touch upon areas which are considered sensitive from the point of view of individual countries' sovereignty.
4. The crisis renewed the sharp divide between the "core" Western European economies and the Central, East and South European "periphery". The latter have been particularly affected by the crisis. The response to this quite unexpected challenge will verify earlier, optimistic market perceptions of the potential cross-country solidarity within the EU. It could either speed up horizontal/geographical integration in Europe by bringing more countries to the EMU and EU enlargement processes, or draw new dividing lines between the "core" and the "periphery" and "multi-speed Europe".

One of the first lessons offered by the crisis is the necessity to increase, at least temporarily, the EU's fiscal potential, which would allow providing rescue packages to both troubled financial institutions and member states in a coordinated way. This may be done by authorizing the European Commission to borrow on behalf of member states for the above mentioned purposes and create a kind of emergency fund. In addition, the EU must work to complete the lacking elements of the Single European Market architecture such as the European System of Financial Supervision.

The recent crisis has also revealed several other institutional dilemmas, for example, whether the system of a rotating EU Presidency guarantees an effective response to unexpected shocks, taking into consideration its short-term horizon (half year), the unequal capacities of individual member states to address global and pan-European issues, and the various national interests and policies of member states.

Going beyond the EU borders, both the Union itself and its member states must be ready to coordinate their policies in many important areas (financial regulation and supervision, monetary policy, fiscal policy, trade policy, etc.) with other major partners in both the developed and developing world, and transfer some of their sovereignty to the global institutions if needed.

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