

# Transforming Economic Governance of the Eurozone

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On October 21 2008, Nicolas Sarkozy, argued that Europe needed better economic government because 'we have endowed ourselves with a currency, a central bank, a single monetary policy, but not an economic government deserving such a name'. In Sarkozy's opinion, the true economic government is the Eurogroup, that holds meetings at the level of the Heads of State and government.

In this essay, we argue that, indeed, Europe needs better economic governance, and that such governance cannot be limited to inter-governmental policy coordination in the Eurogroup. Europe needs a truly democratic 'economic government'---one accountable to the European Parliament and possessing the necessary fiscal and budgetary powers---to cope with present and future international crises. Indeed, the President of the European Central Bank, Jean-Claude Trichet, has very clearly indicated the limits of today's European economic institutions. 'The Stability and Growth Pact [SGP]', he said, 'is the legal framework we have as a quid pro quo for the fact that we lack a federal budget and a federal government' (Trichet, 2008).

For the EU's citizens, European governance is whatever is singled out by mass-media: eg, European Council meetings and the more sensational pronouncements of our national leaders. However, it is only in a Europe of supranational institutions that common decisions can be taken and made operational. Although so-called political realists see the nation-state as central, and Community institutions forming little more than a 'superstructure', we would argue conversely that it is only thanks to the existence of the EU that member-states have been able to hold the financial crisis in check. Moreover, it is not just finance that has a global dimension. Environmental reform is a challenge that the EU will be unable to face alone unless it negotiates the necessary remedies in cooperation with other major international actors.

## *Causes of the financial crisis*

The proximate causes of the financial crisis have been well-described by Alan Greenspan, a non-neutral witness of the crisis.

'Global financial intermediation is broken. That intricate and interdependent system directing the world's saving into productive capital investment was severely weakened in August 2007. ... [In] the wake of the Lehman Brothers default on September 15, 2008, the system cracked. ... Credit-financed economic activity was brought to a virtual standstill. The world faced a major financial crisis" (Greenspan, 2008).

The deeper causes of the crisis go unmentioned. There are at least two interlinked elements which date back to the 1970s and 1980s. The first is the rise of neo-liberalism, launched by Thatcher's government in Britain and by Reagan's in the USA. A particularly important feature of this doctrine was the application of the efficient market hypothesis (EMH) to the financial sector. The EMH says inter alia that the less financial markets are regulated by the public sector, the more easily private savings will find the best investment channels. The EMH revolution led to a substantial reorganization of financial markets in the US and, indirectly, in the rest of the world. It was further sanctioned by the repeal of the Glass-Steagall Act in 1999 by the Clinton administration, an Act originally approved in 1933 as a measure designed to curb the speculative excesses of the Great Depression.

When the distinction between commercial and investment banks was scrapped in 1999, it became possible to greatly increase the market for new financial products and to raise the credit multiplier in respect to the banks' invested capital. Financial assets were repackaged, reclassified according to their risk level and re-deposited with another bank. In this way, banks were able to rid themselves of their asset-backed securities (ABS), apportioning risks over a wide public and obtaining fresh capital for further investment. The illusion was thus created of an almost limitless increase of the volume of loans---and equally of no need for prudential control by the overseeing authorities because an efficient market was capable of guaranteeing an almost perfect relationship between security values and their yield---which included the reward for the risk, accurately calculated using highly sophisticated models

The second underlying cause of the financial crisis is the rise of huge global financial imbalances. In the 1980s it was mainly industrialized countries such as Germany and Japan that soaked up surplus dollars. From the 1990s onward, this role was taken on by emerging countries and, in particular, by China, which accumulated enormous dollar reserves. Such global imbalances have enabled the international financial market to grow in spectacular fashion. Suffice it to note that the broad derivatives market, which amounted to \$75tr in 1997 about 2.5 times the world's GDP, ten years later in 2007 it was worth \$600tr dollars, or 10 times world GDP (Beddoes, 2008: 10). As to US indebtedness, the sum of the public and private debt in the US amounts to 350% of its GNP, while in Europe it is half that figure (Altomonte, Nava, 2008: 5).

To prevent a financial crisis from recurring, the rules of international finance must be changed. Such matters cannot be dealt with by one country alone. The USA is---and will remain for many years---the pre-eminent global economic power, but can no longer be allowed to export financial and monetary rules that jeopardize the world economy. Regulating international finance, reforming the world's currency and embarking on a sustainable development path are challenges that must be addressed jointly.

#### *A European Finance Minister?*

The creation of European Monetary Union (EMU) did not solve the problem what role the European Central Bank should adopt in emergency situations. Article 105.5 of the Maastricht Treaty assigns the competence for 'prudential supervision' to the national level. Only after a unanimous decision can the Council 'confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings' (Art.105.6). So far, the Article has remained a dead letter.

The ECB since its inception has asserted the need for EU-level supervision. In 2002 the ECB's President, Wim Duisenberg, asked that its competences be widened, but the Council of Finance Ministers refused. Instead, the Lamfalussy Report recommended the creation of EU ad-hoc committees for supervision. But such committees lack power for the simple reason that the rescue of a credit institution may require a large injection of public money. Such a division of supervisory powers is patently contradictory. Tommaso Padoa-Schioppa (2004: chap. 5) observes that financial institutions are increasingly exposed to shocks originating beyond national boundaries, and that such shocks normally are contagious, leading to much bigger trans-national effects than in the past. It is now generally accepted that a single market with a single currency requires not just harmonized rules but a single supervisor.

In 2007-08 when the financial crisis spread to Europe, it soon became apparent that, first, the ECB would carry out its role of lender of last resort and, secondly, that the liquidity crisis was turning into a solvency crisis. Following a bank run in late 2007, the British government nationalized Northern Rock in February 2008, and part-nationalised Bradford & Bingley in September of the same year. Around the same time, the governments of Belgium, The Netherlands and Luxembourg invested €11.2bn in Fortis, while Dexia received a further injection of capital by the Belgian, French and Luxembourg governments. Moreover, in September 2008, the Irish government announced an unlimited warranty for all its bank deposits.

Pan-European coordination of these national initiatives was becoming urgent, and it was suggested that a European emergency fund be set up to rescue the credit institutions in difficulties. Indeed, the French Presidency of the Union, on the occasion an emergency meeting it convened in Paris on October 4 2008, hinted at a proposal to create a 'European Federal Fund' worth €300bn. But the proposal was rejected by the Germans. The crisis of the European banking system continued. A second meeting was convened in Paris on October 12, this time with all members of the Eurogroup in attendance together with representatives of the European Commission, the ECB and the British government. (Britain in the meantime had launched a rescue plan for a selected group of its larger banks.) At this meeting it was decided that the government guarantees would be provided to the main banking groups for the issue of securities for a five-year period, and that governments would participate in refinancing those banks in worst difficulties, meaning that no bank would be allowed to go bust. In addition, the level of protection of bank deposits was jointly set at €50, 000, and a commission was set up for reforming the supervisory system of the financial sector.

These decisions successfully calmed the markets and reassured savers. In the days that followed, EU governments announced a series of national intervention plans totalling €1,873bn (the US plan had amounted to only \$700bn), or about 15% of EU-15 GDP over several years. Europe, acting in a concerted way, thus succeeded in checking the most acute phase of the crisis, but at least two notable breaches of the EU's institutional structure emerged.

The first concerns using State aid to bail out private banks. The Treaties' norms forbid State aid, unless authorized by the Commission. Of course, the Commission has stepped in ex-post, but only once it was clear that the national governments were determined to rescue their own banks. What we are seeing is a return to national protectionism in disguise. If such violations become systematic, the principle of the single market will be put in question.

Secondly, in the absence of a European Finance Minister or of an adequate Community budget, a power vacuum has been created that jeopardizes the survival of monetary union; this vacuum also provides an excuse for resorting to massive national bailouts, the total cost of which will probably prove much higher than that of creating an efficient European-level insurance scheme.

Discussion has now begun on the reform of the European supervision system. The Belgian Prime Minister in 2008, Yves Leterme, called for setting up a European Fund subsidized by the EIB. 'At the end of September [2008], Leterme observed, 'the Belgian financial sector was shaken by a serious crisis. Fortis, our main bank, [and] Dexia, the third-biggest bank and [an] insurance company have been hit by the consequences of the international financial crisis. These institutions own activities equivalent to about three times the Belgian GDP,



and the value of their deposits is higher than national income'.

Belgium was not in a position to cope with a second crisis alone. The call for a European Insurance Fund was supported by other experts too: Gros and Micossi, 2008; and Lanoo, 2008, as was the proposal to institute a European system of financial supervisors based on the model of the European system of central banks, retaining tight coordination between European and national authorities. These proposals doubtless were a step in the right direction, but they sidestepped key structural problems; namely, the supervision of financial markets, and—crucially—Europe's budgetary powers. Financing the European Fund through the European Investment Bank is merely a convenient screen behind which the question remains obscured of how to finance European-level fiscal policy. If a further banking crisis occurs, who will authorize financial intervention? Could the resources of an EU Fund be used by all member-states or only by some?

The stability of the EU's monetary and financial system is a European public good. As such, it must be backed by European fiscal resources. The solution to the problem is simple, and several economists have come to the same conclusion (Schinasi and Texeira, 2006). There must be a European budget financed by 'own resources', the management of which is entrusted to the European Commission responsible before the European Parliament. The European budget should include a special budgetary heading for urgent and exceptional interventions. The use of funds in emergency situations should be decided by the Commission – at the request of the European Finance Minister – after seeking an opinion from the ECB and the supervising body. The Commission should be fully accountable of its decisions to the European Parliament. Such a proposal has not been seriously considered so far, mainly because it is at odds with the taboo of national fiscal sovereignty.

#### *A European Keynesian plan with national funding*

The financial crisis and has driven European governments to ditch their deep-rooted prejudice against Keynesian policies. To understand the situation – in part the product of prevailing academic doctrine of recent decades excessively focused on the supply-side – one must go back to the Maastricht compromise of 1991, when it was decided implement monetary union without increasing the EU's budgetary powers. The Stability and Growth Pact, agreed in 1997, transformed the compromise into a Treaty that forced national budgets to conform to tight fiscal parameters. It is worth recalling that the Pact was conceived in order to ensure 'monetary and financial stability' and that the word 'growth' was an afterthought meant to placate those who would have preferred a less rigid arrangement. The implicit meaning of the Pact is that fiscal policy and growth must remain strictly national competences. The European Union deals with growth, development and employment only from the viewpoint of coordinating the national programmes.

Jacques Delors, the Commission President who pushed the Maastricht Treaty through, was the first to realize the deficiencies of the compromise, and tried to remedy the situation by proposing in 1993 a Plan for 'Growth, Competitiveness and Employment' (CEC, 1993) which should have given a long-term growth impulse to the European economy, allowing it to create by the year 2000 more than 15 million new jobs through a series of structural investments in trans-European networks, in information technology, in research, in education and in professional training. The Delors Plan envisaged overall annual expenditure for the period 1994-1999 of 20 billion ECUs (euros), or about 0.33% of European GDP—of which €5.3bn would have been charged to the Community budget, €6.7bn provided by the EIB, €7bn financed by Union bonds and €1bn by bonds secured by the European Investment Fund.

The Delors proposal was, in essence, a plan to increase the productivity and the competitiveness of the European economy, aimed more at stimulating supply than at boosting demand. In the event, the Council of Finance Ministers (Ecofin) soon took it upon itself to bury the project, refusing to provide the money despite the support of the trade unions and the European Parliament. Only in 2000, after years of slow growth was the so-called Lisbon Strategy launched, based on the philosophy of the Stability Pact. Lisbon gives the Commission the task of 'coordinating' national plans: growth is thus dependent on the impulse provided by the governments of the member-states. This strategy has been a failure. The national governments pursue national, not European priorities. The European economy has continued to devote too few resources to research and innovation, to tolerate high unemployment levels and a low level of public and private investment.

The recent Commission document entitled 'A European Economic Recovery Plan' (CEC, 2008), approved by the European Council on 11-12 December 2008, differs from the Delors Plan in that it does not aim to achieve sustained growth in the medium-long term, but rather 'to inject purchasing power into the economy, support demand and stimulate confidence'. It is a 'macro-economic, anti-cyclical', short-term plan: its effectiveness is meant to be tested in the course of 2009, and the programmed financing covers the two-year period 2009-2010. It totals €200bn, equal to 1.5% of EU GDP—of which 0.3% is to be funded by the European Union and 1.2% by the member States.

The European share of the Plan (0.3% of EU GDP) is innovative because it is meant to complement a second project approved by the European Council, namely, the "energy-climate package 20-20-20". This package is at the heart of the EU's commitment to reduce greenhouse gas emissions by 20%, to reach the 20% level of renewable energies and to save 20% of energy by 2020. The Commission's Plan provides for a series of

investments whose purpose is not just to make the European economy more competitive, but also to "green the economy", greatly decreasing CO<sub>2</sub> emission thanks to an increase in energy efficiency, energy saving and to the introduction of clean technologies---in particular in the building and automotive sectors.

The social aspect of the Plan focuses on the creation of new jobs and the protection of jobless workers by means of a strengthened European Globalization Adjustment Fund and a European Social Fund. Special terms for financing and supporting innovation are provided to small firms. In addition, a '2020 Fund' for energy, climate change and new infrastructure ('the Daisy Fund') is envisaged which will co-finance (together with national institutional investors) a number of innovative projects.

However, EU-level financing of the Plan is almost entirely entrusted to the EIB, which is authorized to issue bonds worth €30bn in the years 2009-2010. The other grants come from already allocated monies in the Community budget (although it should be noted that €5bn is taken from unspent sums that should have been distributed to the member States). The rest of the plan (about €170bn) is to be financed by the member-states themselves, who have pledged not to exceed the limits imposed by the Stability Pact. Consequently, not all countries will be able to contribute with the same effectiveness to economic recovery. Countries like Germany, with balanced accounts and low public debt, have a wide margin for manoeuvre. Heavily indebted countries like Italy and Greece, will hardly be in a position to boost Europe's aggregate demand significantly. Indeed, a group of economists (Saha, von Weizsäcker, 2008) have estimated the Plan's overall fiscal impact in the year 2009 to be equivalent to 0.6% of EU GDP, reaching 1.2% of EU GDP if the credit-related incentives are fully effective.

Secondly, one should note that if the share of this Plan financed by member-state level investment is high, free-rider behaviour will be encouraged on the part of those governments which, in the absence of any national recovery plan, expect to reap some of the multiplier benefits. The remedy for this problem is simple. It would suffice to increase the percentage of supra-national (EU level) expenditure to 50% or more, while ruling that such investment be 50% co-financed from national resources. Should the European co-ordination prove ineffective and the resulting national plans prove inconsistent with one another, the net contribution to growth produced by the national incentives will be lower than a supra-national European contribution produced by the same level of expenditure

The third problem is that the proportion of the Plan financed by European resources is relatively small, probably due to member-states' refusal – foreseen by the Commission – to issue EU bonds, as provided for in the Delors Plan of 1993. Fourthly, the less-virtuous countries will be forced to obtain money from the financial market, at less favourable conditions than more virtuous countries. A more efficient European plan would have shared out the cost of its financing more equitably. Finally, it is assumed that even if that part financed by European resources is small, the old doctrine – that growth is led by 'locomotive economies' like Germany – will prevail in the end. This is a serious snag, because it encourages free-rider behaviour on the one hand, and on the other it results in 'virtuous' governments refusing to pay too. In sum, the miserly contribution of supra-national EU resources feeds national selfishness and produces effects liable to bring about the failure of the entire project.

Even in this case, as in the case of the emergency fund, the decisive obstacle is the fiscal problem. The European Union needs its 'own resources'. This is an abstract principle, proclaimed in the Treaties but disregarded in practice. More than 70% of the EU budget is financed by national contributions, and the member-states require that the budget shall not exceed 1% of the Community's GDP. The European budget (which must balance annually) is seen as an appendix to national budgets, not as an instrument of the European economic policy. That is why the additional financial resources necessary to cope with the economic crisis have been obtained through the EIB, a body subordinate to the national governments. The cost of Europe's poor economic governance is a disjointed Union, unable to implement efficient policies.

What European proposals for a new world economic order?

Our main criticism of the EU Plan for economic recovery concerns its internal coherence. However, there is a more general aspect to consider. The financial crisis has had global effects: any partial plan, even one covering an economy of continental dimensions like the USA, the EU, China, Russia, etc. will be ineffective unless the solution is dealt with in global terms. We limit ourselves to two considerations.

The first regards the depth of the financial crisis and its duration. Banking crises since the Second World War have generally lasted for several years, with unemployment reaching levels higher than 7% on average while public indebtedness has generally reached levels of 80% because governments have needed to use fiscal policy to mitigate the harmful consequences of the crisis (Reinhart and Rogoff, 2008). These average values apply to crises occurring in one or more countries, but barring the Great Depression of 1929, we have no past experience of a truly global crisis. There are reasons for thinking that in the absence of world co-operation, the consequences of today's crisis may be much more harmful than in the past.

Secondly, the internationalization of the economy, even if ill-regulated, did allow for the establishment of a division of labour between numerous countries. International macroeconomic relationships take time to build. Balance of payments positions are particularly important, with some countries in current account surplus and



others in deficit. If world aggregate demand is expanding, international trade grows, consumption and investment grow and the countries running a deficit can count on capital inflows from those with a surplus.

But financial and economic crisis upsets the picture. Countries with a surplus (eg, Germany, China, Japan) will see foreign demand of their products decline. Countries with a deficit (eg, the USA, Turkey, South Africa) risk suffering a drastic reduction in their financial flows. Domestic fiscal policies aimed at re-launching demand are necessary, but they are put at risk because each country tried to support its own domestic production and employment. The US government will support the US automobile industry; the European Union will do the same, and so on. In consequence, some enterprises will survive only thanks to public subsidies, while in other cases countries will try to stimulate exports by devaluing their currency. The fabric of international division of labour will be torn in many places and in consequence world productivity will fall.

Relying on one (or several) large economies to act as the locomotive of world recovery may not work. Taking the US example, some economists reckon that even a stimulus equivalent to 5-6% of GDP is insufficient to fill the deflationary demand gap (Godley, Papadimitriou and Zezza, 2008). The aggregate multiplier effect of a series of national expenditure plans aimed at stimulating national employment may be lower than that of a single plan coordinated on a world scale (Montani, 2008: 186-191).

The argument in favour of stronger EU economic governance cannot be limited to economics alone; it affects the interests of the world political community. This helps explain why the EU has pressed for a new Bretton Woods; why it supports the resumption of trade negotiations in the framework of the Doha round and is preparing itself for the post-Kyoto round of negotiations on climate change. What is essential is for the EU to develop a consistent strategy for reform and to speak with only one voice in world conferences.

Consider the first problem. It is often argued that the international organizations created at Bretton Woods are inadequate; what is less clear is how we should reform them. Despite their limitations, these international organizations have functioned for half a century, mainly thanks to US hegemonic power in assuring the supply of certain indispensable international public goods; eg, security (at least for the western world), free(r) trade and international monetary stability. Without such public goods, the international economic order could easily degenerate into anarchy; ie, a return to the beggar-thy-neighbour policies of the 1930s.

Today, international public goods must be guaranteed by reformed institutions. A new power structure is necessary where a voice is given not just to the USA, the EU and Japan, but to emerging powers like China, India, Brazil, Russia and the smaller countries that want to participate in the management of world affairs. In short, reform is about recognizing that the world is multipolar, and that the peaceful management of interdependence can be achieved. The crucial problem of the 21st century is, indeed, to reconcile countries' independence with their interdependence.

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